

1987

Comment letters to the National Commission on Commission on Fraudulent Financial Reporting, 1987 (Treadway Commission) Vol. 1

Data General

Bernard B. Lynn

Jefferson Bankshare

New Alternatives Fund

CTS Corporation

See next page for additional authors

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_sop

 Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

Data General; Lynn, Bernard B.; Jefferson Bankshare; New Alternatives Fund; CTS Corporation; Drexel University; Jaenicke, Henry R.; Health Care Affiliates; Pittway, Jonathan; Philip, Manfred E.; Smith, Willis A.; Mobil Corporation; Bramlett, Robert W.; Cassano, Joseph M.; Medalist Industries; Saul, Ralph S.; Jones, Reginald H.; Dairy Mart Convenience Stores; Lombard Associates; Defense Contract Audit Agency; National Association of Accountants; FMC Corporation; New York State Society of Certified Public Accountants; Kansas City Power & Light Company; General Electric Company; Hirsch, Melvin L.; United Guardian; DynCorp; Palm Desert National Bank; Central and South West Services; Nova Natural Resources Corporation; Household International; Dockweiler, Raymond C.; University of Missouri-Columbia; Hillenbrand Industries; National Association of Accountants; Public Service Electric and Gas Company; Telecommunications; Littlefield, Edmund W.; Sterling Drug; General Re Corporation; Williams, Doyle Z.; Service Fracturing Company; GTE Corporation; R. H. Macy & Company; Crockett, John M.; American Society of Corporate Secretaries; Procter & Gamble Company; Goodyear Tire & Rubber Company; Anheuser-Busch Companies; Riggs National Bank; McDermott, Will & Emery; Royal Insurance; Rice, Steven; Multimedia; Burlingame, John F.; Kemp, Francis; NCNB Corporation; Honeywell International; Hershey Entertainment and Resort Company; Institute of Internal Auditors. Calgary Chapter; Crowe Chizek & Company; Public Service Indiana; Persons, W. R.; USX Corporation; Gary, Stosch, Walls & Company; Neff, Francine; Louisiana Land

Authors

Data General; Bernard B. Lynn; Jefferson Bankshare; New Alternatives Fund; CTS Corporation; Drexel University; Henry R. Jaenicke; Health Care Affiliates; Jonathan Pittway; Manfred E. Philip; Willis A. Smith; Mobil Corporation; Robert W. Bramlett; Joseph M. Cassano; Medalist Industries; Ralph S. Saul; Reginald H. Jones; Dairy Mart Convenience Stores; Lombard Associates; Defense Contract Audit Agency; National Association of Accountants; FMC Corporation; New York State Society of Certified Public Accountants; Kansas City Power & Light Company; General Electric Company; Melvin L. Hirsch; United Guardian; DynCorp; Palm Desert National Bank; Central and South West Services; Nova Natural Resources Corporation; Household International; Raymond C. Dockweiler; University of Missouri-Columbia; Hillenbrand Industries; National Association of Accountants; Public Service Electric and Gas Company; Telecommunications; Edmund W. Littlefield; Sterling Drug; General Re Corporation; Doyle Z. Williams; Service Fracturing Company; GTE Corporation; R. H. Macy & Company; John M. Crockett; American Society of Corporate Secretaries; Procter & Gamble Company; Goodyear Tire & Rubber Company; Anheuser-Busch Companies; Riggs National Bank; Will & Emery McDermott; Royal Insurance; Steven Rice; Multimedia; John F. Burlingame; Francis Kemp; NCNB Corporation; Honeywell International; Hershey Entertainment and Resort Company; Institute of Internal Auditors. Calgary Chapter; Crowe Chizek & Company; Public Service Indiana; W. R. Persons; USX Corporation; Gary, Stosch, Walls & Company; Francine Neff; Louisiana Land and Exploration Company; St. Louis County Council. Office of the County Auditor; Michael W. Maher; University of Chicago; Merck & Company; Upjohn Company; Howard Hughes Medical Institute; General Mills; Mitchell Rothkopf; CSX Corporation; Clark Management Services; Ford Motor Company; Philip Morris Companies; Becton Dickinson and Company; Pennsylvania Institute of Certified Public Accountants; William Lundquist; Northeast Utilities; Dayton Hudson Corporation; Newell Rubbermaid; Maryland Association of Certified Public Accountants; San Diego Gas & Electric; Freeman Properties; Southwestern Bell Corporation; Ameritech; National Association of Accountants. Management Accounting Practices Committee; Baird, Kurtz & Dobson; Walter O. Baggett; Manhattan College; Texas Instruments; Philip F. Jacoby; American University; United States. Department of Education; Howard Savings Bank; DuPont; American Express Company; Machinery and Allied Products Institute; Washington Gas Light Company; Rockwell International; ITT Corporation; Pennzoil Company; AT&T; Financial Executives Institute; Kimberly-Clark Corporation; ThomasNet; Theresa Dailey; Bankers Trust Company; Wells Fargo Bank; PepsiCo; National Commission of Fraudulent Financial Reporting; and James C. Treadway

TABLE OF CONTENTS
COMMENT LETTERS FOR
PUBLIC DISCLOSURE

Commentator

1. Data General
2. Bernard B. Lynn, CPA
3. Jefferson Bankshare, Inc.
4. New Alternatives Fund, Inc.
5. CTS Corporation
6. Henry R. Jaenicke, Drexel University
7. Health Care Affiliates, Inc.
8. Jonathan Pittway
9. Manfred E. Philip, CPA
10. Willis A. Smith
11. Mobil Corporation
12. Robert W. Bramlett
13. Joseph M. Cassano, CPA
14. Medalist Industries, Inc.
15. Willamette Industries, Inc.
16. Ralph S. Saul
17. Reginald H. Jones
18. Dairy Mart Convenience Stores, Inc.
19. Lombard Associates
20. Defense Contract Audit Agency
21. National Association of Accountants, Stephen Lawler
22. FMC Corporation
23. NYSSCPA
24. Kansas City Power & Light Company
25. General Electric Company
26. Melvin L. Hirsh
27. United-Guardian, Inc.
28. DynCorp
29. Palm Desert National Bank
30. Central and South West Services, Inc.
31. Nova Natural Resources Corporation
32. Household International
33. Raymond C. Dockweiler University of Missouri-Columbia
34. Hillenbrand Industries
35. National Association of Accountants, Alfred King
36. Public Service Electric and Gas Company
37. Telecommunications, Inc.
38. Edmund W. Littlefield
39. Sterling Drug, Inc.
40. General Re Corporation
41. Doyle Z. Williams, USC
42. Service Fracturing Company
43. GTE Corporation
44. R.H. Macy & Co., Inc.

Commentator

45. John M. Crockett
46. American Society of Corporate Secretaries, Inc.
47. The Procter & Gamble Co.
48. The Goodyear Tire & Rubber Company
49. Anheuser-Busch Companies
50. Riggs National Bank
51. McDermott, Will & Emery
52. Royal Insurance
53. Steven Rice
54. Multimedia, Inc.
55. John F. Burlingame
56. Francis Kemp, President, NCNB Corporation
57. Honeywell
58. Hershey Entertainment and Resort Company
59. The Institute of Internal Auditors-Calgary Chapter
60. Crowe Chizek & Co.
61. Public Service Indiana
62. W.R. Persons
63. USX Corporation
64. Gary, Stosch, Walls & Co.
65. Francine Neff
66. The Louisiana Land and Exploration Co.
67. St. Louis County Council, Office of the County Auditor
68. Michael W. Maher, The University of Chicago
69. Merck & Co., Inc.
70. The Upjohn Company
71. Howard Hughes Medical Institute
72. Household International
73. General Mills, Inc.
74. Mitchell Rothkopf
75. CSX Corporation
76. Clark Management Services
77. Ford Motors Company
78. Philip Morris Companies, Inc.
79. Becton Dickinson and Company
80. PICPA - letter from William Lundquist
81. Northeast Utilities
82. Dayton Hudson Corporation
83. Rubbermaid Incorporated
84. Maryland Association of Certified Public Accountants
85. San Diego Gas & Electric
86. Freeman Properties, Inc.
87. Southwestern Bell Corporation
88. Ameritech
89. National Association of Accountants - Management Accounting Practices Committee
90. Baird, Kurtz & Dobson
91. Walter O. Baggett, Manhattan College
92. Texas Instruments
93. Anheuser-Busch Company
94. Philip F. Jacoby, American University
95. United States Department of Education

Commentator

96. The Howard Savings Bank
97. DuPont
98. American Express Company
99. Machinery and Allied Products Institute
100. Washington Gas Light Company
101. Rockwell International
102. ITT Corporation
103. Pennzoil Company
104. AT&T
105. Financial Executives Institute
106. Kimberly-Clark Corporation
107. SNET
108. Theresa Dailey
109. Bankers Trust Company
110. Wells Fargo Bank
111. PepsiCo, Inc.
112. John Jamison, College of William & Mary
113. CPC International
114. Office of Comptroller, Department of Banking and Finance
115. Thompson, Greenspon & Co., P.C.
116. F. W. Woolworth Co.
117. The Midland Company
118. The Stanley Works
119. American Brands, Inc.
120. Eli Lilly and Company
121. Delmarva Power
122. Barry Wright Corporation
123. Public Oversight Board
124. Virginia Power and Electric Company
125. Seidman & Seidman
126. Primark Corporation
127. Arthur Andersen & Co. - Public Review Board
128. FDIC
129. Gulf Canada Corporation
130. NCNB Corporation
131. Eamon Kelly, President of Tulane University
132. Texaco, Inc.
133. The Boeing Company
134. Carolina Power & Light Company
135. Xerox Corporation
136. BellSouth Corporation
137. Canadian National
138. A. Tom Nelson, University of Utah
139. Curtis C. Verschoor, DePaul University
140. Colorado Society of CPA
141. Board of Governors of the Federal Reserve System
142. NASBA
143. MSU System Services
144. ABA
145. Washington Public Power Power Supply System

Commentator

146. General Motors Corporation
147. Pacific Gas and Electric Company
148. Premark International, Inc.
149. Bank Administration Institute
150. General Dynamics Corporation
151. Life Investors, Inc.
152. Sears, Roebuck and Co.
153. Greyhound Corporation
154. Sovran Financial Corporation
155. The Black & Decker Corporation
156. The Goodyear Tire & Rubber Company
157. Ashland Oil, Inc.
158. Bob Spilman
159. Shell Oil Company
160. John Zick
161. Gordan Pilcher
162. Dr. Carol Inbery, California State University
163. 3M
164. Avon Products, Inc.
165. Consolidated-Bathurst, Inc.
166. Chevron Corporation
167. National Council of Savings Institutions *acclg Arsen*
168. Thomas Dyckman - Committee of the American Association of ~~Accountants~~
169. Contel Corporation
170. First Chicago
171. American Standard, Inc.
172. Southern California Edison Company
173. Public Service Company of Colorado
174. W.R. Grace & Company
175. Unocal Corporation
176. Sonat Inc.
177. Hershey Foods Corporation
178. Atlantic City Electric Company
179. Eaton Corporation
180. Champion International Corporation
181. Thomas Holton
182. Norton Company
183. National Association of Accountants, John Arme
184. Monsanto Company
185. Pharmaceutical Manufacturers Association
186. May Department Stores Company
187. AmSouth Bancorporation
188. Schering-Plough Corporation
189. IBM Corporation
190. Aetna Life and Casualty
191. Citicorp
192. The Business Roundtable
193. Valero Energy Corporation
194. Scott Paper Company

Commentator

195. Washington Mutual Savings Bank
196. Johnson & Johnson
197. PPG Industries, Inc.
198. Endevco, Inc.
199. The Midland Company
200. Office of City Auditor, Portland, Oregon
201. American President Companies, Ltd.
202. W.M. Ellinghaus
203. Chief executives of eight large CPA firms
204. American Institute of Certified Public Accountants
205. The Timken Company
206. Robinson Grant & Co., P.A.
207. Central Louisiana Electric Company, Inc.
208. The Institute of Internal Auditors
209. Federal National Mortgage Association
210. J.S. Parker
211. U.S. Home Corporation
212. Office of Comptroller, City of New York
213. International Paper Company
214. Merrill Lynch & Co., Inc.
215. The Dow Chemical Company
216. Continental Illinois Corporation
217. Anheuser-Busch Companies
218. PriceWaterhouse
219. United Virginia Bankshares
220. Yellow Freight System, Inc. of Delaware
221. Patrick J. F. Gratton
222. Warner Lambert
223. Pacific Telesis
224. *Comptroller General of the United States*
225. *International Minerals + Chemical Corporation*
226. *Bristol-Myers Company*
227. *Fifth Third Bancorp.*
228. *Briercroft Savings Association*
229. *United Water Resources*
230. *Consolidated Edison Company of New York, Inc.*
231. *University of Illinois at Urbana-Champaign*
232. *Procter & Gamble Company - see also 47*
233. *U.S. House of Representatives - John Dingell*
234. *(Wm.) Wrigley Jr. Company*
235. *(J.C.) Penney*



4400 Computer Drive, Westboro, MA 01580
Telephone (617) 366-8911

May 1, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Gentlemen:

Although I am not quite certain on what basis I was sent a copy of the Exposure Draft of your Report, I appreciated getting it. I now am taking advantage of your offer to comment thereon.

I agree in principle with the Exposure Draft. "The Tone at the Top" and accountability are invaluable in terms of protecting and conserving assets, reputation included. However, I submit that Paragraphs 320 and 330 (page 175) under "Scope of Work" ignore the role of business oriented security departments, and the need for internal auditors and security personnel to work in ways which compliment each others efforts.

The Report makes no allowance for the existence of security departments as essential to successful business operations. Instead it conveys the impression that the internal audit function is the sole protector of a company's assets.

Security is, or certainly should be, equally responsible for protecting and conserving those assets. It also is the proper venue for conducting those investigations which are unrelated to financial matters, and for generally overseeing compliance with corporate policies and procedures in matters which are not of a financial nature.

Over time I have found more security directors who acknowledge the value of internal audit than I have internal auditors who will admit that security also performs an essential service. The Exposure Draft tends to perpetuate this. In my opinion this does a disservice to the business community.

Sincerely yours,

Harvey Burstein
Corporate Director
Safety/Security
Staff Attorney

HB/11a

Bernard B. Lynn
Certified Public Accountant

Consultant — Government Contracts

May 4, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sir or Madam:

I appreciate receiving a copy of the Commission's April 1987 exposure draft and the opportunity of submitting my views on this comprehensive product. Despite its extensive coverage, I was disappointed to find the draft completely ignored the significant area of fraudulent financial reporting in connection with national defense procurement.

Although financial reporting relating to procurement involves every federal department and agency, I have limited my comments to the defense field. The Administration's annual budget request for national defense again exceeds \$300 billion. Adding defense-related expenditures by NASA, Departments of Energy, Commerce and Transportation and others, and the super secret ("black") programs, the funds for which are scattered throughout the budget without identification, indicate appropriations approximating \$350 billion. Even in today's economy, this is not an insignificant figure.

Rather than again detail my views on this point, I have attached a copy of my December 26, 1986 letter to Mr. Treadway which I believe is equally pertinent to the April exposure draft. The essence of my suggestions is that the Commission should at least recognize the special problems involved in financial reporting relating to federal procurement which arise when the General Accounting Office (GAO), the various federal inspectors general, and the federal contract auditors, especially the Defense Contract Audit Agency (DCAA), demand, and in many instances are obtaining, access to companies' internal audit reports and working papers, minutes of boards of directors meetings, and just about every corporate record and paper, regardless of its remoteness to government contracts and irrespective of its confidentiality.

GAO has recently initiated legislation under which the larger defense contractors would be required to submit extensive periodic financial and cost information about sales, costs and profits on both government and unrelated commercial work. This data would be attested to by the companies' independent CPAs and submitted to the Office of Management and Budget (OMB). GAO is particularly insistent that it obtain statutorily mandated access to all records and officials of the companies, and the CPA firms, and OMB.

National Commission on Fraudulent Financial Reporting, page 2

Many of us involved in this area are persuaded that financial reporting relating to procurement in an environment where federal government investigators and auditors have gained access to virtually every corporate document and official in their zealous search for fraud merits special consideration. I am certainly not recommending extensive digression into this area at the expense of the overall subject of fraudulent financial reporting. On the other hand, it does not seem appropriate to completely ignore this subject.

Nor is interest in this matter limited to the major defense contractors such as Boeing, Lockheed, General Dynamics, McDonnell Douglas, Raytheon and other large companies heavily involved in defense contracts, and numerous smaller companies a substantial portion of whose work consists of such contracts. General Motors and Ford in the automotive field, for example, perform on many such contracts and the latter company was recently compelled by subpoena to make available to DCAA auditors some of the most intimate internal control and management records of that company. In other fields, companies such as General Electric, Westinghouse, Sylvania, and RCA, to mention but a few, also share this interest.

And then, of course, there are the CPA firms, the "Big 8," and many others whose reports and working papers would become available to government auditors/inspectors under this legislation.

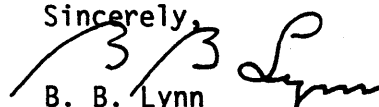
I do not find representatives of the above mentioned companies referred to in the exposure draft. As to CPA firms, all of them maintain separate "specialty" organizations whose efforts are devoted solely or mainly to consulting with the firms' clients on financial and cost reporting and related internal controls concerning government contracts. Thus you may have consulted with a senior partner of a major accounting firm who devotes very little, if any, time to this area.

As to other organizations, representatives of the Financial Executives Institute have testified and submitted position papers relating to the problems created by the governmental intrusion into every facet of companies' financial and cost data. Despite FEI's considerable interest in this matter, I wonder whether the officials so involved have had any input into the exposure draft.

Many members of the Institute of Internal Auditors have been undertaking special instruction, on a crash basis, to revise their programs to avoid fraud allegations by defense and GAO auditors/inspectors, and a number of these firms have engaged CPA firms with expertise in this area to assist them. I must assume that the AICPA and IIA representatives involved in your study did not include the many members of these organizations devoting so much of their effort to these problems.

I appreciate that your very comprehensive and commendable product is in its late stages and can understand that the exposure draft will not be subjected to extensive revisions. I would urge you, however, to at least put forth an intensive effort to develop a perspective on fraudulent financial reporting relating to defense (and to a lesser extent, other federal) procurement. There are highly placed officials in the companies mentioned earlier, and others, and partners in all major CPA firms, who are dedicated almost entirely to these problems. At the least, it seems to me, a task force should be established to develop an appendix to your final report, to demonstrate an awareness of this subject.

Sincerely,



B. B. Lynn

BBL:r/attach.

December 26, 1986

James C. Treadway, Jr., Chairman
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Dear Mr. Treadway:

Many thanks for the copy of your November 18 Houston speech on "A Pre-Exposure of the Commission's Exposure Draft."

For reasons outlined below, my interests in this area focus mainly on its relationship to procurement by the federal government, especially the Department of Defense (DOD). This involves certain different and unusual facets which, if time permits, might well be incorporated, even if briefly, in the final draft.

A few words may be useful in explaining the nature of my interest and indeed why, it seems to me, the accounting profession should evidence greater interest in this facet than indicated by AICPA meetings and publications at both national and state levels.

On a personal note, submitted just so you would understand where I'm coming from, I am a recent recipient of the AICPA 40 year honorary membership. Throughout, most of my interest and attention have focused on the financial aspects of defense procurement. My government service includes over a decade with the Defense Contract Audit Agency (DCAA), including 4 years as that Agency's national director. As you know, DCAA is responsible for auditing the financial representations of firms proposing and performing on DOD contracts, as well as contracts awarded by NASA and several other federal departments and agencies.

I spent almost an equal period of time with one of the "Big 8" firms, providing consulting and management advisory services to the firm's clients engaged in government work and, for the last several years have been performing this type of work for my own clients.

Our burgeoning federal budget now includes about \$300 billion for DOD, a substantial portion of which is spent for the acquisition of weapon systems, supplies and services. Related procurement is also made by NASA, Department of Energy, General Services Administration, and other departments and agencies. I shall not take the time or space to present the voluminous, related statistics because I am certain arrays of figures are not necessary to establish the importance of this area to our economy and to financial reporting.

Recent years have witnessed an unprecedented preoccupation by the federal government with "procurement fraud," a term emphasizing but not limited to accounting and financial reporting matters. This interest and related activities, including incredible increases in the number of auditors and investigators added to the federal payroll, seem to exceed the comparable interest and activity in the other areas.

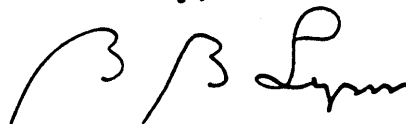
The Inspector General Act of 1978, as amended, established IG organizations in virtually every major federal department and agency, with major missions of detecting and reporting on fraud, and assisting the Justice Department in prosecuting the perpetrators. Semiannual reports are submitted by each IG to the President's Council on Integrity and Efficiency and the PCIE issues consolidated reports trumpeting savings, detections of fraud, waste and abuse, etc.

Fraud detection is big business in the federal government far beyond the SEC and all IGs; the General Accounting Office (GAO), and other federal organizations publish Hotline numbers and addresses to which one and all are exhorted to report suspected fraud. Encouraged (and prodded) by the DOD IG, Department of Justice, GAO, and certain congressional elements, DCAA is currently devoting unprecedented time and cost in fraud detection. Charges and allocations of costs to DOD contracts which the auditors previously considered as questionable or erroneous, are now scrutinized meticulously to determine whether a suspicion of fraud might conceivably be reported.

A number of the largest contractors, as well as many smaller ones, are being continually accused of fraud and are undergoing damaging trials in the communications media and before congressional investigating committees. In some instances, the government fails to sustain its charges; in others, contractors are suspended or debarred, and individuals convicted. The current heavy government emphasis on fraud in this area is referred to as the "criminalization of procurement."

I believe the problem of fraudulent financial reporting in defense procurement presents significant and unusual facets which merit consideration by your Commission. I have discussed some of them in the attachment to this letter.

Sincerely,



Bernard B. Lynn

BBL:r
Attach.

22

FRAUDULENT FINANCIAL REPORTING - SPECIAL PROBLEMS FOR DEFENSE CONTRACTORS

As noted briefly in the covering letter, the 1980s have witnessed unusual government preoccupation with "fraud, waste, and abuse." The major focus has been on so-called "procurement fraud," a general term which includes fraudulent financial reporting as well as other forms of fraud.

The books, records, financial reports, income tax returns, and other data of defense contractors are examined in considerable detail by the Defense Contract Audit Agency (DCAA). These examinations range from occasional visits by "mobile" teams to continuous audit/investigation by resident teams which, at the larger contractors, may consist of 40 or more full time DCAA auditors and concurrently by a larger number of contract administration representatives, such as cost and price analysts, who also delve into various records.

Access to Records

Financial representations by contractors relating to procurement include:

Pricing proposals, consisting of estimated costs and proposed profits to perform contracts which the government has indicated it will award. Such proposals are generally required except for small purchases and "sealed bid" contracts.

Proposals for annual billing and final indirect expense rates which are used for bidding, interim billing, progress payments, and other purposes.

Interim and final contract cost submissions where the initially negotiated contract price is subject to revision based upon ultimate cost, performance, and other factors.

Termination settlement proposals submitted when the government terminates contracts for its "convenience."

Claims for equitable contract price adjustments where the costs of performance have been increased by formal or constructive changes by the government, including delays and disruptions and defective government-furnished materials.

The mission of the government contract auditor is to examine the contractor's records which support these representations and issue an advisory report to the contracting officer. The auditor "questions" any cost which he believes is unreasonable in nature or amount, or where the portion allocated to a contract exceeds that computed in accordance with certain "Cost Accounting Standards" established by the government, or which are otherwise "unallowable" based on government acquisition regulations or the auditor's opinions. As noted in the covering letter, considerable emphasis is currently directed to identify accounting and reporting errors with fraud.

Traditionally, some contract auditors have been interested in examining contractor records which appeared to be beyond those necessary to support the contractor's representations. Whether in the nature of fishing expeditions or for other purposes, such interests were restrained by most contractors who believed, as stated in a judicial ruling that "government auditors should not roam unrestricted throughout a contractor's plant." Accordingly, auditors' requests for records beyond those considered essential to support the financial and cost representations were frequently challenged by contractors and differences were settled either by compromise or by intervention of the contracting officer.

2e

Defense contractors have been on the receiving end of considerable criticisms from the DOD IG, DCAA, GAO and certain congressional elements. The storm of hostility culminated in the enactment of the 1986 DOD Authorization Act., P.L. 99-145, on November 8, 1985. This act, among other things, granted subpoena authority to DCAA, authority which even contracting officers do not have. Although the conference report accompanying this bill specified that in providing the subpoena authority Congress did not intend to expand the kinds of records to which DCAA may have access, the Audit Agency, in the opinions of many observers, implemented the statute for just such purposes.

For example, in a recent subpoena duces tecum, DCAA demands included the following records for the five years preceding that date: all records of the contractor's internal audit department, including reports, working papers, work schedules, personnel records, etc.; all annual and five-year plans (budgets and forecasts); and all minutes and associated records of board of directors meetings. These records are in addition to the voluminous data which this company has been providing to the government resident auditors over many years.

In June 1986, the President's Blue Ribbon Commission on Defense Management (Packard Commission) reported: "Our study of defense management compels us to conclude that nothing merits greater concern than the increasingly troubled relationship between the defense industry and government." The Commission noted the increasing attention and resources being expended by DOD to detecting unlawful practices but expressed the concern that "a plethora of departmental auditors and other overseers - and the burgeoning directives pertaining to procurement - also have tended to establish a dysfunctional and adversarial relationship between DOD and its contractors. Widely publicized investigations and prosecutions have fostered an impression of widespread lawlessness, fueling mistrust of the integrity of defense industry."

The Packard Commission submitted a number of cogent recommendations for both DOD and industry and its suggestions for improved self-governance by contractors parallel, in part, those presented as the tentative conclusions of the National Commission on Fraudulent Financial Reporting. Assisted by a major CPA firm, the Packard Commission formulated a number of specific suggestions, including the establishment or enhancement of internal audit capability. In this connection, however, the Commission stated:

Government actions should not impede efforts by contractors to improve their own performance. The Commission is concerned that, for example, overzealous use of investigative subpoenas by Defense Department agencies may result in less vigorous internal corporate auditing.

* * * * *

Government actions should foster contractor self-governance. DOD should not, for example, use the investigative subpoena to compel such disclosure of contractor internal auditing materials as would discourage aggressive self-review.

Although many of the Commission's recommendations have been implemented in whole or in part, no action has been taken to date to place any restraint upon DCAA's increasing demands for virtually limitless access to contractor records by issuing subpoenas or threats of doing so.

Voluntary Disclosures

Among the many recommendations to improve contractor self-governance, the Packard Commission concluded:

Each company has the obligation to self-govern by monitoring compliance with the federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.

Although it has taken little or no action to date on such recommendations as discouraging the use of subpoenas, which produce a chilling effect on aggressive internal auditing, and eliminating the redundancy of contractor surveillance by DCAA, DOD IG, various contract administration organizations, etc., the Department of Defense moved promptly to prod industry to adopt the recommendation for voluntary disclosure.

The ink had scarcely dried on the Packard Commission's final report to the President when the Deputy Secretary of Defense wrote to the top 100 defense contractors encouraging them "to consider adopting a policy of voluntary disclosure as a central part of your corporate integrity program."

DOD's program for voluntary disclosure includes contractor commitment to "cooperate fully with the government in any ensuing investigation or audit." As to incentives for abandoning their constitutional rights under the fifth amendment, DOD promised industry it would "seek to expedite the completion of any investigation and audit conducted in response to a voluntary disclosure, thereby minimizing the period of time necessary for the identification of remedies deemed appropriate by the government." Understandably, the dubious advantage of expeditious investigation and following action resulting from the voluntary disclosure was viewed as a questionable incentive by many contractors.

The Secretary of Defense vigorously pursued this program. In an address delivered on October 30, 1986, he joined in urging voluntary disclosures by companies doing business with DOD. He acknowledged, briefly: "We cannot ask industry to develop codes of conduct, and then leave fuzzy the legal implications of various actions. Government must uphold its end of the bargain." Unfortunately, Secretary Weinberger did leave this matter fuzzy. Nor did the audience find encouragement in the statistics he provided on the increasing number of contractor suspensions and debarments in past years and his promise: "The 1986 figure will be even higher."

With increased DOD prodding, including the availability of the Department's high level officials to address meetings and seminars, a number of such events have taken place and are scheduled for this Winter to discuss voluntary disclosure. DOD speakers emphasize the value of this program but continue to be extremely vague when questioned about the incentives for contractors to make such disclosures. As a result, many attorneys have been vigorous in cautioning contractors of the possible adverse implications.

As a final point on this subject, DOD recently announced its proposal to include a "Contractor Fraud, Waste, and Abuse Awareness Program" clause in prime and subcontracts exceeding \$25,000. In essence, contractors will be required to maintain an ongoing program orienting their employees as to the kinds of actions which could constitute various kinds of fraud, the employees' responsibilities to report any actions which indicate the possibility of fraud, and their freedom from being discharged, demoted, discriminated against, or from other reprisals for reporting possible fraudulent activities. The clause requires that posters must be conspicuously displayed containing information about Hotline telephone numbers and related instructions for reporting suspicions of fraud.

Major contractors are continually being importuned to enter into advance agreements with the government which set out the kinds of programs they shall establish to assure ethics in business practices, including voluntary disclosures. At this writing, the government representatives in the Defense and Justice Departments remain vague as to the consideration which will be accorded to these companies beyond expeditious investigation and related action. Although a number of companies have entered into such agreements, they are being cautioned by their attorneys of the inherent dangers. For example, at a recent seminar the point was made that a company or its officials who report that their employees may have committed fraudulent acts open themselves to litigation by such employees which may subject them to monetary and other penalties associated with slander and libel.

Perhaps the work of your Commission is too far along or perhaps the commissioners may consider fraudulent financial reporting relating to government contracting somewhat too specialized a subject to warrant special coverage. I would hope, however, that the commissioners give this matter serious consideration in the light of the substantial impact on so many businesses, of every size, which are involved in this area.

If the Commission does devote some consideration to this area, I would hope its forthcoming recommendations will include a recognition of the environment in which defense contractors currently operate. Specifically, what would be your recommendations regarding (1) the internal audit function where all of its work and personnel must be made completely available to DOD auditors/investigators, and (2) voluntary disclosures to the government of fraud or other irregularities?



BERNARD B. LYNN, CPA



Jefferson Bankshares, Inc.
123 EAST MAIN STREET, CHARLOTTESVILLE, VIRGINIA 22901

May 5, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sirs:

Thank you for the April 1987 Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting.

Overall, your report is excellent.

With respect to Objectivity of the Internal Audit Function on pages 33-34, I offer the following comments:

1. One of the better ways to ensure independence and objectivity is to have the Audit Committee approve the expense budgets and staffing levels for the internal auditors. In addition, internal audit salaries should be approved by the Audit Committee. In this manner, the Audit Committee assures the adequacy (credentials, experience, training, size) and independence/objectivity of the internal audit staff.
2. Independence and objectivity should not necessarily preclude the internal auditor from being part of the management team. The internal auditor can be a valuable asset to established management/policy groups so long as his/her role is advisory and not policy making (other than with respect to the audit function itself). The internal auditor can be much more valuable to the organization if he/she has insight to the planning process and direction of the corporation (knows what is going on) rather than having to find out.

With respect to the Audit Committee of the Board of Directors on pages 35-39, there is no mention of the responsibility to oversee or overview the internal audit function. The section on Internal Audit Function and Chief Internal Auditor indicates the reporting relationship with the Audit Committee. The recommendations for the Audit Committee should dovetail those concepts. Why should the Audit Committee be concerned exclusively with the external auditors (principally financial aspects) when the major emphasis of internal audit work is ensuring adequate internal controls are present? Can you have consistent accurate financial reporting without adequate internal controls?

With respect to the Audit Committee Chairman's Letter, the letter should explain in detail any areas that either the internal or external auditors are precluded from auditing and why.

As stated previously, overall I think this report is excellent. If possible, I would appreciate your sending copies of the Exposure Draft to the three external directors of my company that comprise the Audit Committee. Their names and addresses follow:


Henry H. Harrell
Post Office Box 25099
Richmond, Virginia 23230

Alex J. Kay, Jr.
Post Office Box 26603
Richmond, Virginia 23261

Alson H. Smith, Jr.
Post Office Box 422
Winchester, Virginia 22601

Thank you.

Sincerely,



David L. Smith, CBA
General Auditor

DLS:sf

New Alternatives Fund, Inc.

A FUND CONCENTRATING IN ALTERNATIVE ENERGY INVESTMENT

295 NORTHERN BOULEVARD
GREAT NECK, NEW YORK 11021
(516) 466-0808

May 7, 1987

Comment Section
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Ave.
Washington, D.C.
20006

Gentlemen:

RE: Comment, as Solicited, to draft dated May 1, 1987

I write to you on behalf of a publicly registered mutual fund with \$3,500,000.00 in its portfolio.

Your proposal seems limited to public companies. However it would appear to be directed to large public companies. We take one topic for illustration.

Accounting:

Our solo practitioner accountant has his office above a candy store. We are delighted with his service. He has never to our knowledge been sanctioned or sued. He cannot consult with his partners. He has none. If our accountant needed peer review and independent oversight he could not afford us as clients and he has so told us. Nevertheless, when we were audited by the SEC for six working days we came out like a rose. Would we have done better with a large accounting firm whose fees we cannot afford ?

The NASD has recently inquired as to why our investment advisor accounting reports no liabilities. We were obliged to prepare more reports. The answer was - we have none. We pay our bills, usually in advance or upon receipt and borrow no money. Why do we need to make reports like that ? I surmise that the answer is because of reports like yours .

The same kind of comments apply to the rest of your report.

It is almost religious in our country to give praise to small business and to small new business. It is amazing that we come into being and exist when the regulatory structure is examined.

It is my view that your report does not propose for us a solution; it is part of the problem. My comment is : " We have enough regulation. Enforce existing regulation. Fraud was adequately defined more than 300 years ago".

Yours,


Maurice L. Schoenwald, President

CTS

May 7, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:


I read with interest your recent exposure draft of your conclusions on Fraudulent Financial Reporting. In general, I have no problem or negative comments regarding your report. I found it to be very thorough and following along the lines of my own philosophy.

However, I would like to recommend that as an additional step to address the Fraudulent Financial Reporting issue, the SEC should consider requiring some type of reporting regarding the change of Chief Accounting Officers. I feel that this, along with the report on the changing of external auditors, may more thoroughly address this issue.

Regards,

Very truly yours,

CTS CORPORATION



William D. Baker
Controller

WDB/j



DREXEL UNIVERSITY
College of Business and Administration

Henry R. Jaenicke
C. D. Clarkson Professor
of Accounting

509-J Matheson Hall
Philadelphia, PA 19104
(215) 895-2118

May 12, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

First, let me congratulate the Commission and its staff on a job well done. Having said that, however, I wish to comment on the Commission's recommendation that the AICPA should reorganize the Auditing Standards Board to consist of 8 to 12 members, half of them not engaged in the practice of public accounting.


As a long-time observer of the auditing standard-setting process, and as the only non-Board, nonpractitioner member of the ASB's Auditor Communications Task Force (which developed three of the ten recently exposed ASB pronouncements), I urge you to reconsider that recommendation. Your report acknowledges the Commission's recognition that the process of setting auditing standards involves highly technical as well as substantial policy aspects, but the recommendation about ASB size and composition and the suggestion for implementing it do not adequately reflect the relative significance of the first of those two factors.

The three statements developed by the Auditor Communications Task Force (auditor's report, communications with audit committees, and examining MD&A), as well as a fourth issue recently added to its agenda (communicating the auditor's responsibility for systems of internal control when conducting an audit), admittedly involve topics of great interest to financial statement preparers and users (whose input was and will continue to be solicited). But even those topics, which are surely among those with the greatest public policy aspects, required an extensive period of learning and debate over highly technical issues, not to mention countless hours of haggling over equally technical language. I simply cannot imagine what that Task Force and the ASB would have wrought if half of their members had been, like myself, not engaged in public accounting practice. And my

eyes absolutely glaze over when I think about nonpractitioners writing standards on such arcane topics as audit sampling, letters for underwriters, and supplemental mineral reserve information -- topics that are probably more representative of the usual ASB agenda than its high public profile agenda of the past two years.

The goal the Commission apparently seeks -- a heightened ASB focus on and awareness of policy aspects -- is admirable, but it can be accomplished in ways that do not detract from the level of technical knowledge that the Board needs, a level that I believe is only rarely present in nonpractitioners. For example, more nonpractitioners could be added to the present Board, an advisory committee of nonpractitioners could be created, or the Board's Planning Subcommittee, which controls the Board's agenda, could be expanded by the addition of nonpractitioner, non-Board members to serve as an oversight or advisory council. I urge the Commission to consider these or other means of achieving its objectives. What is needed is a means of ensuring that public policy issues are adequately considered, without detracting from the technical, practice-oriented skills that have been one of the Board's greatest strengths.

Very truly yours,



Henry R. Jaenicke

HRJ:jc

HEALTHCARE AFFILIATES, INC.

May 14, 1987

NATIONAL COMMISSION ON FRAUDULENT
FINANCIAL REPORTING
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Commissioners:

I have reviewed the Exposure Draft sent to our corporation and find your recommendations and conclusions very informative. I have been with my company for the past four years and would like to share my thoughts that might possibly be of value to your Commission.

When a corporation or institution is responsible for reporting to the SEC I feel that the education first must begin at this level, with the SEC in conjunction with the various accountancy boards providing the education. (Academic education requirements will take time to institute the required programs and is certainly crucial in long-range planning, but is secondary at the moment).

The SEC requires audited annual reporting, but does require quarterly reports to be audited. This should be changed. If a company wants the benefits of being a public corporation then that company should be required to bare the costs of quarterly audit reviews. Your comments of fourth quarter write-offs is in my opinion a result of the annual audit. Had quarterly reviews be made mandatory by the SEC then write-offs would not have been picked up in audit and reported only in the fourth quarter.

The SEC should require the CPA firms that are registered before them that conduct these audits to make available to the client along with the SEC educational material/classes to make every accounting employee aware of what constitutes fraudulent reporting. In a large company the various internal controls that are suggested and maintained by the audit team are primarily to insure management that no fraud is being perpetrated against them, not the SEC and the public stockholders. Employees that participate in the preparation of financial statements should be required to sign documentation that would be filed supplementally with the the auditors that they are not participating to the best of their knowledge in any fraudulent reporting. This disclosure would be made in the MD&A report to the SEC in the annual and quarterly reporting.

Commission on Fraudulent Reporting
Page 2.

Another reason for quarterly audit reviews is that the footnotes need to be constantly updated. The company's operations, management, risk factors, litigations, proposed operations all change, as well as their financial position. These items are never updated in the quarterly reporting until they are revised at the annual audit between management and the auditing firm. Conceivably a company can be bankrupt and the public would never know until the annual report when the MD&A letter disclosed that it felt that that company was no longer a going concern.

In summation, I feel it is the responsibility of the SEC and the different accountancy organizations to set-up more stringent regulations for corporations; and the educational training to be implemented by the auditing firms performing the audits.

Sincerely,



Pamela Hallam
Controller

410 S. HOLLYWOOD AVE.
DALLAS, TX 75208
U.S.A.

18th May 1987

Dear Sir

Having read your exposure draft, I would like to make the following proposals

- (1) Every public company be required to have an internal audit function, be it one or more persons, headed by a suitably qualified person.
- (2) This person either be a CPA or suitably qualified (a "Certified Internal Auditor" type examination or profession could be instituted as well)
- (3) An internal audit report be included in the company's annual report, addressing many of the standards proposed by the Commission and indicating / attesting to compliance therewith.

Hoping the above are of interest to you.

Yours sincerely

Jonathan Pittaway

MANFRED E. PHILIP
Certified Public Accountant

Member—
American Institute of Certified Public Accountants

May 26, 1987

Mr. James C. Treadway, Jr.
Chairman National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Re: Exposure Draft of May 1, 1987

Dear Mr. Treadway:

I have read the very informative brochure containing the above exposure draft. In general I agree with most of the statements and recommendations and therefore I will limit myself to two points, namely:

1. The standard accountants' report;
2. The role of the boards of accountancy.

1. The Standard Accountants' Report

I refer to my letter of December 15, 1986. In that letter I said that the space available in a company's annual report is simply insufficient to explain the role of the independent auditor, the constraints imposed on the accountant to keep the fee in reasonable bounds and the fact that a historical financial statement does not answer the question what the future will bring which is what creditors and investors want to know. My suggestion is to publish and distribute widely a brochure of approximately 50 pages which explains in detail how historical financial statements are compiled and audited, what are their limitations and what additional information investors and creditors need to know before they can make intelligent decisions.

2. The role of the State Board of Accountancy

I was very disappointed by the restrained language on page 70 describing the toothless tigers which today masquerade as boards of accountancy. Unfortunately most boards regulating professions are governed not by the various professions but by a centralized State Department of Regulatory Agencies which (a) does not want to see, hear or speak any evil and (b) wants to do anything on the cheap. The professions must regain control of the function to police their weak brethren. Since the legislature are not willing to tax the general public for the cost of vigorous enforcement the various professions will have to assess their member for the amount it takes to do the job.

Respectfully yours,

Manfred E. Philip
Manfred E. Philip

WILLIS A. SMITH
815 Norgate Drive
Ridgewood, N.J. 07450

Tel: 201-444-6754

May 28, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006

Dear Sirs:

Thank you for the opportunity to express my comments on the April 1987 Exposure Draft - Report of the National Commission on Fraudulent Financial Reporting. Before expressing my comments, I would like to commend the Commission on their efforts. For many well-run enterprises, the Exposure Draft supports the efforts to establish a control environment that insures proper financial reporting. For those enterprises where the control environment is lacking, the Exposure Draft provides a framework to establish such an environment. My comments as set forth below are based upon my twenty-eight plus years as a public accountant auditing New York Stock Exchange clients and upon my ten plus years as a corporate comptroller and vice president of a Fortune 500 company with world-wide operations.

Before making comments about specific recommendations in the Exposure Draft, I would like to express my views on two areas -- Audit Committees which are treated with importance in the Draft and a subject not treated in the draft, the audit staff of a public accounting firm.

AUDIT COMMITTEES

Your report places great emphasis on the need for enterprises to have audit committees comprised solely of independent directors. You state that:

"An audit committee consisting of independent directors is the primary vehicle a board of directors uses to discharge its responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting. Boards of Directors of all public companies should have an independent audit committee vigilantly overseeing the financial reporting process."

Unfortunately your theoretical concept of Audit Committees is far removed from the real world. It should be recognized that in all companies except those in financial difficulty or similar circumstances that management picks the directors for their companies, whether public companies or private companies. Management also decides committee membership. Management decides the frequency and content of meetings of directors and meetings of committees of directors. Under such circumstances, it is difficult to assume that an audit committee will be established that could operate with the oversight responsibility for financial reporting. My experience indicates also that the quality of the members of the audit committees varies considerably. Many of the directors assigned to the audit committees have little experience in the area of financial reporting

and little interest in the subject. It is interesting to observe that managements appear reluctant to appoint retired public accountants to their boards. Where an audit committee member has the necessary financial reporting background, it often happens that his or her questions concerning the financial reporting process are resented by the other members of the committee and sometimes by the management as an intrusion into the management of the company. Since the audit committee's meeting time is usually for a limited time -- for example, one hour every quarter or two hours every six months, etc. -- questions by a knowledgeable member sometimes restricts the topics that can be covered.

In order to achieve the Commission's objective to have an "independent audit committee vigilantly overseeing the financial reporting process," it would appear that some alternative method must be devised whereby companies would be required to appoint an independent qualified person picked by the stock exchange as a director and as the chairman of the audit committee. Furthermore, the stock exchange should also require the listed company to permit the appointed chairman to set the dates and the length of the audit committee meetings. The qualities and experience necessary for qualification as an "independent qualified person" might be determined by the Securities and Exchange Commission with assistance of the public accounting profession and other bodies.

AUDIT STAFF OF A PUBLIC ACCOUNTING FIRM

The Commission's report sets forth a number of excellent recommendations concerning the audit process, but fails to make any recommendations concerning the organization of an audit team. The Commission should keep in mind that not all partners of accounting firms do not make audits. Furthermore, in many accounting firms, review of working papers is made by a manager and not by the partner in charge of the audit.

The actual auditing of an enterprise is performed by very young auditors. The senior or supervisor in charge of the audit may have three or four years experience. The audit team manager with perhaps four to six years experience usually has other teams to supervise and therefore is only periodically reviewing the work of each team. The problem is further confounded by the extreme turn-over of team personnel. It is not uncommon to have a complete new team of auditors each year. It has been my experience that continuity of team personnel is a must if an indepth, knowledgeable audit is to be conducted. Otherwise, as the team performs the audit following the audit program devised for that client, there is always the possibility that the inexperienced personnel will not see the "trees for the forest." Reviews will accomplish little, other than to see that the program steps have been initialed.

I strongly recommend that the Commission consider this very important area of detection and perhaps prevention of fraudulent financial reporting as an area where improvement by accounting firms is needed. Some recommendations might be made as follows:

1. Accounting firms should prepare plans to reduce the turnover of audit personnel, so that audit staffs become more experienced. Working conditions, salaries and benefits should be improved in order to encourage longer periods of employment.
2. The time requirements for promotion to senior, supervisor positions should be extended substantially.
3. Changes in audit teams on an engagement from year to year should be avoided or kept to a minimum. The senior audit personnel on an engagement should have had at least three years prior experience on that engagement and a total of at least six years experience as an auditor.
4. The audit committee should be informed as to the qualifications and experience of the audit team each year.

COMMENTS REGARDING SPECIFIC RECOMMENDATIONS

Pages 39 and 41 - Management Report and Audit Committee Chairman's Letter. The illustration of a Management Report as set forth on pages 188 and 189 is entirely too long. The example should be shortened. It is also suggested that information as to the Audit Committee's activities should be included in the Management Report, thereby eliminating the Commission's recommendation for a separate letter.

Page 42 - Quarterly Reporting. The recommendation that Audit Committees should approve financial results prior to public release is an unreasonable recommendation that would unduly delay the publication of quarterly results. I suggest that the following sentence should be inserted to replace the second sentence of the recommendation:

"This oversight should include reviewing such results with financial management and determining the results of the quarterly financial results review by the independent public accountants."

Page 43 - Setting Standards for Internal Control. Internal controls vary from company to company because of organization and type of business. Therefore, an appropriate internal control system for one company is entirely inappropriate for another company even in the same business. A number of the public accounting firms issued material on internal control procedures in connection with the Foreign Corrupt Practices Act and these manuals have been helpful to companies in the review of their internal control policies under that Act. However, it is my opinion that any attempt to arrive at a "common reference point" with regard to internal control procedures would result only in an academic exercise of little, if any, benefit. I urge the Commission to delete this recommendation from their final report.

Page 49 - Timely Review of Quarterly Financial Data. As I recall, the SEC rules regarding the review of quarterly financial data permitted a review by independent accountants together with an opinion thereon or no review at the time of the quarterly statements. However in the latter case, the review would be required in connection with the annual audit and if the review indicated that the previously submitted

quarterly figures required revision, that the quarterly results included in the annual report had to indicate the revision. Of course, it was also necessary to file the appropriate report with the SEC of the need for revision. In practice, many companies opted to have the quarterly financial data reviewed prior to public release without the public accountant's opinion. Therefore, it would seem that there is little need for the Commission's recommendation. In the commentary accompanying the recommendation, the Commission comments on the fourth quarter write-offs. The Commission should take note that goals and plans for the ensuing year are usually adopted in the fourth quarter and that many of the write-offs result from decisions reached in connection with goals and plans for the next year.

If any of my comments or suggestions are unclear or require amplification, I will be pleased to respond to your questions.

Very truly yours,



Willis A. Smith

Mobil Corporation

150 EAST 42ND STREET
NEW YORK, NEW YORK 10017-5666

PHILIP W. MATOS
CONTROLLER

June 5, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

REPORT OF THE NATIONAL COMMISSION
ON FRAUDULENT FINANCIAL REPORTING
EXPOSURE DRAFT - APRIL 1987

Dear Sirs:

Our comments on four of the Commission's Recommendations for the Public Company contained in Chapter 2 follow:

Recommendation: Public companies should ensure that their internal audit functions are objective (page 33).

We agree with this recommendation. We do not agree, however, on the need for the Chief Executive Officer (CEO) to conduct regularly scheduled meetings with the chief internal auditor on at least a quarterly basis. The Mobil chief internal auditor has direct and unrestricted access to the CEO when needed, and has a scheduled annual meeting with the CEO. He is free to meet more frequently as required. We believe that, in these circumstances, it is inappropriate to mandate quarterly meetings.

Recommendation: Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant (page 34).

We agree with this recommendation. We strongly believe that the responsibilities of the internal auditors and the independent public accountants should be clearly defined and mutually understood, and that audit work should be properly coordinated to avoid omission or duplication. The work of the internal auditors complements and supports the work of the independent public accountants. We do not agree, however, on the necessity for the internal auditors to be involved in the audit of financial statements at the consolidated

Mobil

level. Considering their greater degree of independence, we believe it is preferable for the independent public accountants to be primarily responsible for the audit in this area. In addition, since the independent public accountants are responsible for certifying the financial statements, their involvement at this level must, of necessity, be substantial and it may be difficult to effectively involve the internal auditors in this work.

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year (page 41).

We agree that it would be beneficial to include in the annual report to stockholders a section describing the audit committee's responsibilities and activities during the year. Since the proposed section would form an integral part of the annual report and the Form 10K which is signed by all the directors, we do not see the need for such information to be presented in letter form signed by the chairman of the committee.

Recommendation: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release (page 42).

We disagree with this recommendation. We agree that the audit committee's responsibilities should include oversight of the quarterly reporting process as a part of their general oversight function. We do not agree, however, that the committee should be required to approve in advance the release to the public of quarterly financial results since such responsibility is neither practical nor compatible with the Commission's characterization of the role of the audit committee as an overseer of the financial reporting process. We believe that the audit committee's role should be to satisfy itself that the control structure within the company is adequate to protect the integrity of the quarterly reporting process.

Sincerely,


Philip W. Matos

JRB/sc

June 6, 1987
6 Bouton St. No. 8
Stamford, CT 06907

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

I join the many who commend you for the excellent service you and the staff of the Commission have rendered by preparing the Exposure Draft of your report. It contains many suggestions valuable to government as well as to the private sector. Practices of many governmental entities will doubtlessly be influenced, and improved, by your report. For this reason I comment from the governmental perspective, though your report is primarily intended to apply to investor-owned corporations.

I would like once again to call to your attention one concern, which may not have received sufficient attention in the original draft. Unless I overlooked it, the report does not contain any explicit caveat about the audit committee's reliance on the internal auditor. I believe that this discussion should be expanded. It would also be desirable if the report explicitly recognized that the greater diversity of, and conflict among goals of "stakeholders" of government (that is to say, among those affected by government and to whom it should be accountable), may imply the need for even more extensive steps to assure accountability than is necessary for investor-owned corporations. Specifically, the sort of dual relationship you envision for internal audit, vis-a-vis management and the audit committee, may be even more problematic in government. I am not suggesting that you modify your recommendations, for they are valuable, merely that the report could be improved by more extensive consideration of this potential problem.

Recently I had the opportunity to hear one of your staff assistants (provided by one of the large accounting firms) discuss the report. When I asked about this point, he replied to the effect that the Commission had heard some say that its recommendation regarding internal audit would not work, but that at least private meetings with the internal auditor would absolve the audit committee of responsibility, and place the burden on the internal auditor. This may not be a fair paraphrase of his comment, nor an adequate representation of the Commission's consideration of the issue, but, to the extent it is accurate, I would submit that this approach is neither fair to the internal auditor nor calculated to assure the reality of accountability to the committee and the shareholders. In government, especially, such ambiguity may be the source of problems.

It is truly difficult to balance the factors involved to find the optimal arrangements for accountability. I have no simple formulation to offer, but one approach to improve the report might involve more explicit recognition of the dilemma, an assertion that the Commission nevertheless recommends the procedures described, and an explanation of its rationale. This might be expanded with an example of the kind of adjustment that may be desirable in government, including explicit recognition that the audit committee must rely primarily upon the independent auditor to verify the representations of management, including those of an internal auditor reporting to management. I believe that a majority of a government's audit budget should be devoted to independent audit (whether performed by an independent public accounting firm or by employees of the unit reporting administratively to the audit committee), rather than to internal audit. In industry it is common belief and practice that an increasing share of the audit budget can and should be devoted to internal audit, as the corporation becomes larger and more complex. This pattern does not apply to government. Another way of formulating this observation is to say that the role and scope of the independent audit in government must necessarily be broader than in industry. In improving practice for industry, the Commission should be careful to avoid inadvertent and unintended adverse effects on accountability arrangements in government.

I appreciate the opportunity to comment on the report, and look forward to widespread acceptance of its recommendations.

Very truly yours,



Robert W. Bramlett

June 9, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

In response to your request for reactions, suggestions, and opinions on the Report of the National Commission on Fraudulent Financial Reporting, enclosed for your consideration is the presentation " Certified Public Accountant - Public Trustee - Publicly Owned Company".

Acknowledgment of receipt and your comments would be appreciated.

Sincerely,

Joseph M. Cassano
Joseph M. Cassano, CPA (Retired)
5915 Craig Street
Springfield, Virginia 22150

Member
AICPA
DC Institute of CPA

Enclosure

CERTIFIED PUBLIC ACCOUNTANT
PUBLIC TRUSTEE - PUBLICLY OWNED COMPANY

INTRODUCTION

The introduction to the "Report of the National Commission on Fraudulent Financial Reporting" summarizes its three major objectives by stating that "our mission has been to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence".

This presentation respectfully proposes reform not included in the meritorious Treadway Commission Report, and is based on the supposition that the accounting profession should innovate a more effective audit committee in the publicly owned company (SEC registrant).

Basically, the function of the audit committee of a publicly owned company should be expanded to the status of a quasi-judicial function, within the framework of the publicly owned entity.

The quasi-judicially empowered audit committee should logically be administered by individuals who are licensed in the legal or accounting professions, and preferably licensed in both professions.

Presently, the qualified certified public accountant is uniquely competent to fill this position of trust as a member of the audit committee.

The public trustee concept will enhance the audit committee function with the same degree of professionalism that the CPA has displayed in the independent audit function, and will provide an effective deterrent to fraudulent financial reporting.

IMPLEMENTATION - AICPA

The AICPA should designate and establish a new category of CPA service; namely, "Public Trustee - Publicly Owned Company"; outlining the scope and attribute of the service to be rendered.

The AICPA should define the educational and professional experience qualifications necessary to accept an engagement as a "CPA - Public Trustee".

This specialist would be qualified to serve as a member of the audit committee of a publicly owned company.

The CPA - Public Trustee would retain his independence, even though his observable function may appear to be internal in nature.

The CPA - Public Trustee would serve a single term of 3 or 4 years. If more than one CPA - Public Trustee were required, terms of service would be staggered to expire in different years to maintain continuity of service.

The CPA - Public Trustee, while serving in this capacity, would not be a business associate of any other CPA or CPA firm.

IMPLEMENTATION - PUBLICLY OWNED COMPANY

The publicly owned company would initiate the internal action necessary to retain the services of a CPA - Public Trustee as a member of its audit committee.

The scope of service rendered by CPA - Public Trustees would vary from full time engagements to limited service required; depending on the size, operations, and specific needs of the publicly owned company.

DUTIES OF "CPA - PUBLIC TRUSTEE"

- * Perform the normal duties of a member of the audit committee of a publicly owned company. These duties should not include any managerial responsibilities other than those directly related to the audit committee function.
- * Maintain the degree of independence inherent in audit engagements performed by the public accounting profession.
- * Attend meetings of the board of directors.
- * Exert a quasi-judicial influence on corporate activity, with authority to retain legal counsel.

BENEFITS TO PUBLICLY OWNED COMPANY

- * Opportunity to demonstrate its self-discipline capability by reforming its audit committee function, and consequently, reversing the trend of increased government regulation of its operations.
- * Promotion of investor interest, with concurrent increase in the value of its capital stock or equity interest.
- * Public relations benefit from the projection of an image of integrity and sincere concern for the public welfare.
- * The public trustee concept provides continuity and uniform standards of professional performance in the administration of the audit committee function of a publicly owned company.

BENEFITS TO INVESTORS

- * Creation of an alter ego for the stockholders or equity owners.
- * The public trustee concept could provide a quasi-owner influence on management accountability and performance.
- * Additional assurance of the financial security of their investment. This is especially vital for the expansive pension fund investments which often provide the major source of income for current and future retired persons.

BENEFITS TO ACCOUNTING PROFESSION

- * Enhances its professional image with the public.
- * Expands its sphere of operations in response to a perceivable public need.
- * Preserves the role and responsibility of independent auditors.

CONCLUSION

The present operational structure of the conglomerate publicly owned company is vast and complex, with financial and human resources reminiscent of the original thirteen colonies which formed our nation.

Our form of government has thrived and served the public interest, based on the ingenious premise of the separation of powers through the counterbalance of the legislative, executive and the judicial functions.

Adopting this concept in our present conglomerate publicly owned companies could be the substantial reform needed to respond positively to the rapidly changing environment and to best serve the public interest.

The corporate legislative (directors) and executive (officers) forces, joined by a discerning quasi-judicial (audit committee/ CPA - public trustee) force, creates an effective internal control environment.

Congressional posture on its perception of adequate reform is apparent. Reforms by the accounting profession which are deemed inadequate by Congress could result in additional restrictive government regulation or government audits of publicly owned companies.

Considering all of the factors which contribute to the incidence of fraudulent financial reporting, the public trustee concept could conceivably blend into and supplement some of the concerns and recommendations of the Report of the National Commission on Fraudulent Financial Reporting.

* * *



Medalist Industries, Inc.

June 9, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Dear Sir:

At your invitation, I would like to offer the following comments on the exposure draft of the report of the National Commission on Fraudulent Financial Reporting.

My first comment is that I hardly endorse most of the recommendations herein and I feel that on an overall basis, the report is well thought out and is a constructive step in addressing this problem. However, there are three specific areas on which I would like to make some suggestions for improvement. These are as follows:

1. The mandatory requirement that all companies have an effective and objective internal audit function. I believe there are approximately 20,000 publicly held companies in the United States. I believe Medalist is probably somewhere between the one-thousandth and two-thousandth largest of these 20,000 companies. For your point of reference, I am attaching a copy of our 1986 annual report.

We have operated without an internal audit function for a number of years and really have felt no need to incur the additional costs associated therewith. From my 30 years experience in the financial community, I have surmised that the majority of internal audit functions fall into one of two categories; either they are used as a training or entry level job for people who aspire to a position of divisional controllers, etc. or they become a resting home for older financial executives for a number of years prior to their retirement.

I am sure that there are many fine professional internal audit staffs functioning effectively in larger multi-national companies. However, I am sure that the commission does not envision the type of audit function as described above and which I feel is most prevalent in many of the

National Commission on
Fraudulent Financial Reporting
June 9, 1987
Page Two

companies I have observed over a number of years. The type of function which I am sure the commission is considering would consist of a staffing of at least a few people with secretarial help and in our situation, I feel would only add unneeded cost to our operation.

Although we are a fairly large company, we do operate nine distinct divisions and because of this the relative pieces of the accounting puzzle are relatively small and not unduly hard to control. We operate the corporate staff with a total of 10 people including secretarial help and would see absolutely no need to add two or three people as internal auditors to this group merely because of some regulatory imposed requirement. I feel that in gross size, we are probably in or close to the upper 10% of all publicly held companies and if internal auditing is really inappropriate in our company as it appears to us, I am sure that there are many, many companies smaller than ours for which it would also be inappropriate. In addition, I feel this requirement would be a distinct disincentive for small emerging companies to avail themselves of the public capital markets to finance their growth since companies in this stage of development are probably least in a position to incur the additional two to three hundred thousand dollars of additional expense that an internal audit function would envision.

I do not object to the recommendation per say but I do feel that the recommendation should be tempered to apply only in circumstances where it would appear to be most appropriate. The draft form indicates that all public held companies should have an effective enough objective internal audit function. I think the important thing is that internal control operate effectively and if this can be accomplished in a given set of circumstances without an internal audit function, I feel no need for a regulatory requirement be maintained.

2. My second area of concern is the requirement that the audit committee and outside auditors be involved in the quarterly financial information. I have no objections to management reviewing press releases and announced earnings with audit committee members or, as in our case, as we do with the entire Board of Directors at a regularly scheduled quarterly board meeting prior to the time that earnings are released. However, I do object to the requirement that the outside public accountants review these quarterly results.

National Commission on
Fraudulent Financial Reporting
June 9, 1987
Page Three

I think in some point in time, you have to trust the financial management people to prepare accurate financial information. Your proposal to require that this information be reviewed by the outside auditors, in my opinion, is self-serving to the public accounting profession which I know is one of the sponsors of the commission. If the audit process as such has failed to correct or prevent fraudulent financial reporting on an annual basis, I question the wisdom of the commission in recommending that a work of a less detailed nature which would be an unaudited review would have any positive impact upon the correctness of the information being reported. Why impose a control which is working less than effectively on an annual basis upon the quarterly financial information.

In addition, the whole idea of additional reviews of the quarterly financial information is not consistent with the current requirement for timely financial reporting. In our practice, if we really have any unusual financial accounting problems to be faced in a quarter, we will voluntarily discuss them with our outside auditors prior to preparing our quarterly earnings release. In the absence of unusual items which are infrequent, we prepare a comprehensive memorandum after the release of the earnings detailing the accounting considerations which were used in the preparation of the quarterly financial reporting. A copy of this is furnished to our auditors within a week or two of the earnings release. They have an opportunity to contact us if they are not in agreement with anything in this memorandum or certainly to point out what they feel would be a more proper procedure in subsequent quarters' reporting. This system has worked well for approximately ten years and I really see no reason to change it.

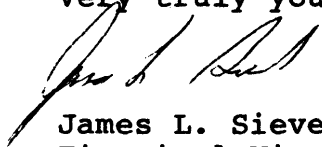
- 3. My third comment is in relationship to the commentary throughout the report about the problem with unusual charges suddenly appearing in financial statements. I do not feel that the imposition of additional reviews by audit committees, outside auditors, internal auditors, etc. will have any impact on this problem. This problem clearly relates to the fact that there are no specific accounting standards or principles on which one can be judged as to the appropriate time to report an unusual item or special charge. I think the correct solution to this problem is to direct or assist the Financial Accounting Standards Boards to develop meaningful accounting principles in this area.

National Commission on
Fraudulent Financial Reporting
June 9, 1987
Page Four

This problem should be no greater than many of the other problems such as lease accounting, mergers and acquisitions, pension accounting, etc. which have been corrected over the years through the development of specific accounting principles.

A general comment is that some of the recommendations do not appear to give any consideration to cost benefit analysis and I would like to point out that if our 20,000 American companies that are publicly held are to continue to operate in the world markets on a competitive basis, there really should be great concern and caution in developing regulatory procedures that require the imposition of additional costs such as internal auditing, outside auditors' review of quarterly results, etc. merely for the sake of meeting some regulatory requirement.

Very truly yours,



James L. Sievert
Financial Vice President
and Treasurer

JLS/ale



Willamette Industries, Inc.

Executive Offices

3800 First Interstate Tower

Portland, Oregon 97201

503/227-5581

June 9, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Re: Exposure Draft

Gentlemen:

At the present time, no one obviously knows what will be the final use of the recommendations of the commission. Therefore, we are writing this response from the perspective that in the future, a portion or all of the recommendations made by the Commission may be enacted into law or carry the weight of official pronouncements such as the FASB or SEC. However, our basic belief is that, like most evils of society, fraudulent financial reporting cannot be legislated away and an additional set of rules has the potential to create significant additional cost without significant additional benefit. We believe it is a tribute to our financial market system that it has and can withstand the rare uses of fraudulent financial reporting, without catastrophic effects in the marketplace.

Nevertheless, we offer the following comments upon the recommendations proposed by the Commission:

1. There has been much criticism over the years of the amount of "boilerplate" language contained in annual reports. It appears that your recommendation that both the audit committee chairman and the chief executive and accounting officers include letters in such report discussing their responsibilities and activities will significantly add to such criticism. We believe that such letters are neither read or used in any way by users of financial statements and are simply to provide ammunition for future shareholder lawsuits should adverse financial conditions develop for whatever reason.
2. In most instances, requiring audit committee review of quarterly reporting will result in additional cost and potential delays in earnings releases. If the intent did exist to publish fraudulent quarterly financial statements, it is highly doubtful that any review by an audit committee would discover such intent. In addition,

National Commission on Fraudulent
Financial Reporting

June 9, 1987

Page 2

with the other steps that are suggested for audit committees, it would appear that if they were not satisfied with the overall environment in which financial reporting is performed this additional step also would achieve nothing. Therefore, the costs of implementing such an approval process would far outweigh the benefits which we judge to be negligible.

3. The establishment of another body to guide public companies on internal control appears as one more layer of bureaucracy in this world. No single body can develop internal control guidelines which are applicable and usable by all companies because of the diverse nature, size and complexity of the companies that would be covered by those guidelines. Countless organizations have issued guidelines for internal controls over the years, most notably by Big Eight accounting firms after the passage of the Foreign Corrupt Practices Act. Another group to study the issue will not add much in the way of beneficial guidelines at this point.
4. We agree that independent public accountants should be more responsive to their responsibility for the detection of fraud. From our perspective of being the one audited, additional audit work, however, does not appear to be the answer. Rather, a redirection of their efforts from trivial, unimportant matters to more substantive issues, i.e., smarter auditing recognizing risks. Far too often it appears that auditors "lose sight of the forest and only see the trees." Until they are required to be responsible for fraud detection, the incentive appears to be lacking for them to change their ways.
5. We strongly disagree with the proposal to require independent public accountants to review quarterly financial data prior to release. Most importantly this will significantly delay the timing of earnings releases. Secondly, if fraudulent financial reporting is taking place when annual financial statements are being audited, the likelihood of anything being discovered in a pre-earnings release quarterly review are remote.
6. With regard to reorganization of the Auditing Standards Board we agree that it would be a welcome addition to have CPA's not currently in public practice serving. We believe this will provide fresh insight and perspectives from industry, academia and others. We do not agree, however, with the recommendation they be non-CPA's. The

National Commission on Fraudulent
Financial Reporting

June 9, 1987

Page 3

educational process necessary to bring many of these individuals up to the same level will reduce the overall effectiveness of the Board.

7. We strongly agree that the SEC should review its current position regarding indemnification. With the pressures of today's insurance markets and the stated desire to improve the overall quality of audit committees and boards of directors, to attract top quality candidates, there must be some assurance they will not be in financial jeopardy from frivolous lawsuits.
8. We believe the Commission is proposing a significant change in the basic nature of the SEC from a regulatory oversight agency to a law enforcement and prosecutorial agency. While obviously the latter has existed and has received much more public attention recently with "insider trading" prosecutions, the proposals appear strongly in favor of increasing the scope and power of the SEC as a law enforcement agency rather than a regulatory body. While not opposed to change, we believe the SEC is already a very powerful agency that doesn't need more powers added to its arsenal. Our primary objections are in the area of additional SEC enforcement remedies and increased criminal prosecution. We believe current powers are sufficient and have proved adequate over the years.
9. Finally, we endorse whole-heartedly the Commission's recommendations for education. This will significantly increase a student's knowledge and awareness of financial reporting ethics and the regulatory process. Unfortunately, this is an area which is overlooked in the drive to know as many facts as possible; all, however, outside of a structured ethical system to use them.

We appreciate the opportunity to comment on the proposals of the Commission.

Very truly yours,



C. W. Knodell
Executive Vice President,
Chief Financial Officer,
Secretary and Treasurer

pdk

16

RALPH S. SAUL
1600 ARCH STREET
PHILADELPHIA, PA 19103

June 12, 1987

Gentlemen:

These comments on the Exposure Draft are submitted in response to the Commission's letter of May 1, 1987 inviting public comments.

The Commission's report clearly demonstrates the ability of the private sector to respond to the need for improving financial reporting in this country. The report serves as a framework for immediate action by all constituencies having an interest in financial reporting. At the same time, it provides a framework for future action.

These comments suggest some minor modifications in the Commission's recommendations with the objective of making them more effective.

The Commission's recommendations with respect to Audit Committees do not fully take into account the problems of the small, publicly held company. While the report acknowledges that in the case of small companies, it may not be possible to implement the letter of the recommendations, it does not suggest procedures for responding to the spirit. Smaller companies, as you know, frequently do not have independent directors and if they do, there may not be enough of them to form an Audit Committee. Because of the difficulty of attracting qualified independent directors to small companies, I think there will be many requests for exemption under the proposed SEC rule. Under these circumstances, wouldn't it make sense to require Audit Committees for larger companies with securities traded on the Amex and in the NASD National Market and then for smaller companies to spell out procedures and controls equivalent to an Audit Committee?

Another recommendation that may cause problems is the recommendation that the Audit Committees should approve in advance the public release of quarterly financial results. For many companies, this may be a cumbersome and unnecessary requirement if the Audit Committee, together with the independent public accountants, perform a regular review of quarterly financial statements. Through an after the fact review, the Audit Committee can introduce the same discipline into the quarterly reporting process as a pre-release review.

While I understand the reason for the recommendation that the Chairman of the Audit Committee include a letter in the Annual Report to stockholders, this recommendation may elevate form over substance. The Commission may receive objections to this recommendation on the ground

Page Two

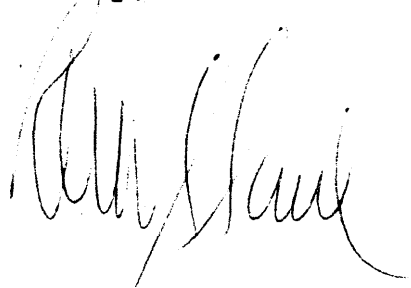
that it exposes directors to additional liabilities. To me, this objection misses the point. Directors do have liabilities and they should not seek to avoid them. My objection to this recommendation is that it may unnecessarily discourage competent people from serving as directors or as Audit Committee members. I believe that the Commission could accomplish the purpose of this recommendation by having the names of the Audit Committee members listed in the Annual Report as some companies now do.

There is a practical problem with the recommendation that the Audit Committee approve in advance each use of management advisory services by the external auditors. Frequently, management will use external auditors for special services in connection with acquisitions, system studies, tax advice and other similar matters on an immediate basis. The requirement that the Audit Committee review each such use of the external auditors in advance and make certain findings with respect to each special use, will inhibit the use of the external auditor for special services. The effect of the Commission's recommendation is to create an incentive for management to use another auditor or consultant when it may be more cost effective to use the independent public accountant.

Finally, there is a real need to raise the status of the independent public accountant both with the Audit Committee and the full Board. All too frequently, external auditors are treated as technicians - not as trusted advisors to the corporation. With the decreasing importance of outside legal counsel, the external auditors are frequently the only independent source of advice to the Board. I hope that the final report of the Commission will emphasize this role of the independent public accountant and recommend ways to bring the external auditor more deeply into the corporate governance process. The quality of the outside audit and auditors on the engagement directly reflect the status and importance assigned by the Board and management to the independent public accountant. The Commission's report should make that point.

I hope these comments are helpful to the Commission.

Sincerely,



National Commission on
Fraudulent Financial Reporting
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Reginald H. Jones
P. O. Box 8300
260 Long Ridge Road
Stamford, Connecticut 06904
(203) 373-2136

June 12, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Gentlemen:

As the chairman of the audit committee of three New York Stock Exchange listed companies, I have read your Exposure Draft with interest. It is a most comprehensive document, both thoughtful and provocative.

I shall confine my comments to those sections of Chapter Two that deal with internal audit and the activities of the audit committee of the board of directors. As a preface to these comments, I wish to acknowledge my general support for the positions taken by the Commission and to emphasize that I am questioning or taking exception only to limited, specific recommendations in the Draft and not to its overall intent nor thrust.

In Section IIIB, the Commission, in discussing the composition of the internal audit staff, may wish to consider adding a sentence underscoring the importance of having EDP specialists on the staff since so much reliance is placed on controls achieved through management information systems.

In the same section there is a statement, "the audit committee should review the appointment and the dismissal of the chief internal auditor." I trust the Commission appreciates that the audit committee must place heavy reliance on the recommendations of the chief financial officer except for the most unusual or egregious situations.

In Section IV, "the Commission recommends that the chairman of the audit committee write a letter describing the committee's activities and responsibilities for inclusion in the annual report to stockholders." I take exception to this recommendation. It is my position that every annual report should contain a statement of financial

National Commission on Fraudulent Financial Reporting
June 12, 1987
Page Two

responsibility signed by both the chief financial officer and the chief executive officer. This statement should cover the work of the audit committee. Further, the proxy statement should list the members of the audit committee, their responsibilities and activities, and the number of committee meetings held. If these practices are followed, a letter signed by the chairman of the audit committee is redundant.

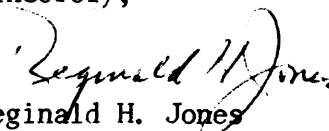
The recommendation that the audit committee approve in advance management advisory services performed by the company's independent public accountant is controversial and debatable. It is usual to review such work at the end of the year when the audit committee receives a letter on such work and fees as provided by the SEC Practices Section of the AICPA. If there should be questions as to the composition or nature of such work or the magnitude of the fees, then constraints can be put on such future work. I realize that such a review is after the fact, but the knowledge that such a review takes place is a restraining influence on activities that could possibly influence the auditor's independence. Further, I question that an advance review could be conducted on a timely basis.

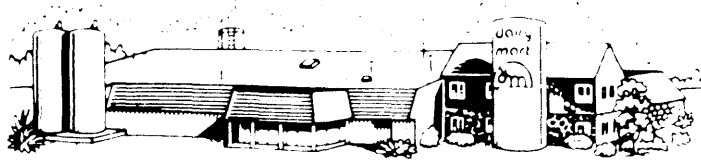
In Section VI, I would suggest the insertion of the word "both" in the recommendation so that the wording reads . . . "discussed with both its old and new auditors"

Further, in Section VI is the recommendation that the audit committee approve quarterly financial results prior to public release. It is not feasible to require such approval, if quarterly results are to be issued on a timely basis. Many corporations do not have a formal review of their quarterly results by independent public accountants, and, even in those cases where such a review is performed, a letter is not always prepared by the public accountants for transmittal to the audit committee. The delay in releasing quarterly results that would result from the Commission's recommendation could be most damaging to shareowners. I do agree that management should inform the audit committee of significant changes in accounting or financial reporting practices, and do this in advance of adopting them, so that the committee can assure itself that the quarterly results released to the public will include reference to such changes. Such a recommendation should not interfere with prompt release of results.

Thank you for providing me with the opportunity to read this Exposure Draft on a topic of great interest to all concerned with comprehensive and accurate financial reporting.

Sincerely,


Reginald H. Jones



dairy mart convenience stores, inc.

240 SOUTH ROAD, ENFIELD, CONNECTICUT 06082

(203) 741-3611

June 15, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sirs:

I am enclosing for you my comments on the Treadway Commission's Exposure Draft Report. As a whole, I believe this is a fine document that should serve to improve the responsibilities and practices of corporations, Boards of Directors and outside auditors. However, I do have some concerns regarding specific areas which are discussed below.

My primary concern is the recommendation on page 49 on the Report concerning timely review of quarterly financial data. I strongly acknowledge that the primary responsibilities for any financial information lies with internal company management. The primary consideration concerning quarterly financial data is for accurate information disseminated on a timely basis for the general investment community. I feel that the requirement to have independent public accountants review such quarterly data will result in delay of the release of this information, and potentially result in a leakage of information rather than in a timely, factual dissemination. Obviously when the outside accountants come in to review, the company has already completed compilation of numbers for release. I believe such a delay can result in more harm than good. In addition, this requirement would add to the cost of the outside accountants' services.

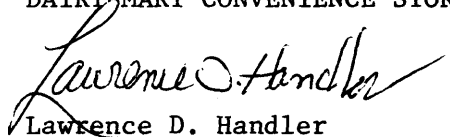
Secondarily to this I have a related concern about the requirement for audit committees approving financial results prior to public release. While I agree in concept, I would like to know more of the specifics of this proposed requirement. Since the audit committee is normally comprised of outside directors whose personal schedules may not coincide with release dates of corporate results, there could be some problems with timely dissemination of data.

My final major concern is the recommendation on page 42 of the Report should a company change its independent public accountants. I am opposed to the proposed rule that a company must discuss publicly the nature of any material accounting of auditing issues discussed with its old and new auditors during the three year period preceding the change. I have no objection, and am in full agreement, that a company should discuss any disagreement concerning accounting or auditing issues. However, the disclosures of normal and recurring accounting and auditing issues will send a wrong message to many readers of such disclosures. There are so many judgement calls in the normal reporting process that I fear this rule would become a giant can of worms.

Thank you for the opportunity to comment on your draft report.

Very truly yours,

DAIRY MART CONVENIENCE STORES, INC.



Lawrence D. Handler
Executive Vice President and Chief
Financial Officer

LDH/kmb

LOMBARD ASSOCIATES

201 SPEAR STREET, SUITE 1600
SAN FRANCISCO, CALIFORNIA 94105
(415) 921-2848

June 15, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

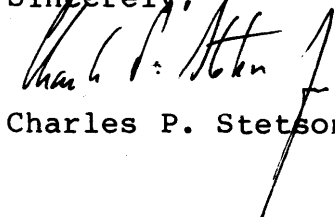
Comments on Exposure Draft dated May 1, 1987

Gentlemen:

The report of your Commission was outstanding and most helpful in understanding an important issue. As an investment banker for 15 years who has worked with many companies and their accountants in raising capital and as a private litigant in a shareholder deviate suit in a company with a failed audit, I particularly appreciate the issues discussed in your report.

The only suggestion for inclusion in the final report is in the area of Peer Review, and I enclose my letter to the SEC with three recommendations which I would also offer to this Commission.

Sincerely,



Charles P. Stetson, Jr.

CPS,Jr:gf

Enclosure

LOMBARD ASSOCIATES

201 SPEAR STREET, SUITE 1600
SAN FRANCISCO, CALIFORNIA 94105
(415) 921-2848

June 15, 1987

Jonathan G. Katz
Secretary
Securities and Exchange Commission
Judicial Plaza
Washington, D.C. 20549

Subject: File S7-13-87

Dear Mr. Katz:

I am writing to commend the proposed rules for "Independent Accountants Mandatory Peer Review". While I am in favor of the rules as promulgated, I believe the rules could be strengthened with respect to individual audit failures.

I raise this issue with a background of 15 years as an investment banker who has worked closely with accountants in numerous financings and a private litigant in a pending shareholder derivative suit.

Audit failures, particularly when they are not picked up by accountants, continue to mislead investors. In the extreme and in this case, such audit failures can involve the most serious fraud on the public investor -- self-dealing, misappropriation, negligence and willful misconduct. There does not appear to be any reliable current mechanism other than expensive litigation to enjoin this kind of activity. Defendants in this type of matter have usually unlimited assets in the form of shareholder capital to defend themselves and to seek dismissal on technical grounds rather than deal with the merits. A recent trend of some concern are attempts to insulate liability to directors and officers by individual indemnification and by statute.

As a result of this experience, I would favor:

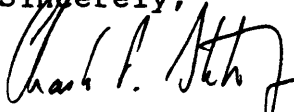
1. Final rules that would as a minimum require the selection and independent review of the audit which is subject of private litigation by another accounting firm
2. Automatic referral of cases involving litigation or commission investigation to Peer Review organizations preferably on an annual basis

Jonathan G. Katz
June 15, 1987
Page Two

3. A mechanism to appeal to an oversight independent accounting board specific audits involving audit failure.

The public trust and confidence would benefit greatly from this kind of review.

Sincerely,



Charles P. Steenson, Jr.

Enclosures



IN REPLY REFER TO

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VA 22304-6178

PFD 7-502

15 JUN 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Gentlemen:

I reviewed the May 1, 1987 Exposure Draft of findings, conclusions and recommendations with considerable interest. The report provides excellent commentary on the factors which frequently contribute to fraudulent financial reporting and many sound recommendations that would serve to reduce the number of observed occurrences.

Content of the Commission report will be of value in completing an on-going assessment of DCAA auditor communications with the senior management officials and boards of directors of large defense contractors.

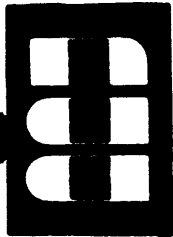
Several of the Commission's recommended changes if implemented, will provide added insight into our annual audit planning process and assessment of internal controls at major contractor locations, and as such we heartily support the commission's efforts. These include:

- Annual reporting on the responsibilities of the audit committee and its activities.
- An annual review by the audit committee of the company's risk assessment process and management's response to significant identified risks.
- Additional public reporting of prior audit issues whenever there is a transition between two public accounting firms.
- Establishing an independent body to provide guidance on internal controls for public companies.

If further comment or assistance is desired, do not hesitate to contact me. I can be reached at (202) 274-7323.

Sincerely,

William J. Sharkey
William J. Sharkey
Assistant Director
Policy and Plans



NATIONAL ASSOCIATION OF ACCOUNTANTS

FOUNDED IN 1919 AS THE NATIONAL ASSOCIATION OF COST ACCOUNTANTS
TULSA CHAPTER

June 15, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Ave, N.W.
Washington, D.C. 20006

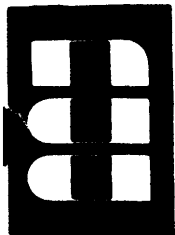
Re: Report of the National Commission on Fraudulent Financial Reporting

I would like to address two areas of the exposure draft of the Commission's report. First, the increased role of the internal auditor. Second, the recommendation for exchange of information between regulatory examiners and the independent public accountant.

The Commission's report makes several recommendations relating to the increased role of the internal auditor and the importance of an effective internal audit function within public companies. The Commission has also made a number of recommendations relating to clarifying the role of the independent public accountant. The Auditing Standards Board of the AICPA has recently published ten exposure drafts of auditing standards that will address many of the Commission's concerns and recommendations.

The Institute of Internal Auditor's study on the role of the internal auditor noted that "There is a trend toward increased reliance by independent public accountants on the work of the internal auditor, particularly in the areas of control evaluation and computer systems." In reviewing the work of both the Treadway Commission and the exposure drafts of the Auditing Standards Board, it appears that all of the recommendations directed at the relationship between internal and external auditors are directed at the internal auditor. The Standards for the Professional Practice of Internal Auditing, Section 550, requires the director of internal auditing to "coordinate internal and external audit efforts." External auditors, however, are under no such direction. SAS # 9 states, "The work of internal auditors cannot be substituted for the work of the independent auditor...." The external auditor may take internal audit work into consideration when planning audit testing, but there must be at least some duplication of the internal auditor's work.

I strongly agree with the Commission's recommendations that all public companies should have an internal audit function and that the work of the internal auditor should be coordinated with the external auditor to prevent duplication of effort. However, public companies will resist pressure to establish professional internal audit departments if the independent public accountant is required to duplicate the work of the internal auditor. Most current audit literature supports revision of SAS # 9. I believe that it would be appropriate for the Commission to recommend review and revision of SAS # 9.



NATIONAL ASSOCIATION OF ACCOUNTANTS

FOUNDED IN 1919 AS THE NATIONAL ASSOCIATION OF COST ACCOUNTANTS
TULSA CHAPTER

The Commission's report also recommends that "financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant." The report, in the discussion of this recommendation, suggests that this concept of sharing of information should be applied to all regulated industries and regulatory examiners. By implication, this recommendation could be carried to operational audit functions of internal auditors and regulatory examiners of the National Transportation Safety Board, or other such government agencies.

In discussing the findings of research studies into the problem of fraudulent financial reporting, the Commission noted that the auditor was often given false or misleading information by management. In an environment where it is already difficult for the independent public accountant to get reliable information, adding the requirement information be exchanged with government regulators would serve to complicate the audit process.

Stephen J. Lawler
Stephen J. Lawler, CIA
Director of Manuscripts
N.A.A., Tulsa Chapter

Note --- The opinion expressed is solely that of the writer and is not intended to propose an official position of the Tulsa Chapter of N.A.A.

FMC Corporation

Executive Offices
200 East Randolph Drive
Chicago Illinois 60601
312 861 6000



June 15, 1987

The National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Gentlemen:

We appreciate this opportunity to comment on the Report of The National Commission on Fraudulent Financial Reporting. We congratulate the Commission on its thorough research and documentation and believe that the report, overall, provides a sound program for restoring faith in the business community. While the incidence of fraudulent reporting has been small, all of the business community has, nevertheless, suffered as a result of its occurrence.

For the sake of brevity, our comments are restricted to those recommendations which we believe are in need of modification.

Recommendation 2: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

It is virtually impossible to establish and maintain an internal control system to prevent fraud, especially if it includes collusion. We suggest rewording the recommendation as follows:

Recommendation: Public companies should establish and maintain a system of internal controls sufficient to provide reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition, and the prevention and detection of fraudulent financial reporting.

Such wording would be more consistent with the text which follows the recommendation and would alleviate our concerns.

Recommendation 6: Public companies should ensure that their internal audit functions are objective.

The National Commission on Fraudulent
Financial Reporting

June 15, 1987

We do not agree that the chief internal auditor should report administratively to the CEO. The internal audit function is an extremely important element in the control system, the maintenance of which is generally the responsibility of the controller or the CFO. To remove the chief internal auditor from the control of the person primarily responsible for the control structure itself would not be an improvement to the system. We believe the objectivity and independence of the chief internal auditor can be maintained through oversight by the audit committee, and we suggest that the report place more emphasis on this relationship.

We also disagree that the chief internal auditor must be an experienced audit professional. Obtaining someone with these qualifications may not be practical for some companies and may be unsuitable for others. We do believe it is important that the audit committee be involved in the hiring and termination of the chief internal auditor.

Recommendation 14: The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

We do not agree that it is necessary or desirable for the audit committee to become involved in operational concerns of this nature. It is important that the committee be made aware of the engagements and the related fees but prior approval is impractical and unnecessary.

Recommendation 16: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

We do not agree that a separate letter from the audit committee is needed in the annual report to shareholders. The management report could include a brief description of the audit committee's duties and the frequency of their meetings, but more than this is information overload. The members of the audit committee are identified in the proxy statement.

Recommendation 17: Management should advise the audit committee when it seeks a second opinion on a significant accounting issue. We suggest the recommendation be reworded as follows:

Recommendation: Management should discuss with the audit committee any significant accounting issue for which an opinion was sought from a second independent public accounting firm.

The National Commission on Fraudulent
Financial Reporting

June 15, 1987

This change should be made to clarify that the discussion with the audit committee could take place after the second opinion is sought rather than concurrently or beforehand.

Recommendation 18: When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

We believe that this recommendation places undue emphasis on disputes over accounting or auditing issues as the reason for changing auditors. There are many reasons for auditor changes, and disagreement over auditing issues is probably the less likely cause. The present Form 8-K disclosure requirements are adequate to keep investors informed of such disagreements occurring within the last three fiscal years.

Recommendation 19: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We do not agree that audit committee approval of interim results should be required prior to public release. The choice of whether to review and approve interim results or to rely on the internal auditors, external auditors or the financial control system, should be a decision of the audit committee. A requirement for prior approval would likely delay the timely issuance of quarterly information to the detriment of the investing public.

We would be pleased to elaborate on any of these comments.

Very truly yours,


David G. Harmer
Controller

jg
2668G

OFFICERS

BERT N. MITCHELL, CPA
 ROBERT FAGLIARONE, CPA
 RICHARD J. GUILTINAN, CPA
 ARTHUR S. HOFFMAN, CPA
 MARY A. LEVINE, CPA
 JAMES W. LIPSHIE, CPA
 JACOB ASSAEL, CPA
 IRVING N. MCCARTHY, CPA
 ROBERT L. GRAY, CPA

PRESIDENT
 PRESIDENT ELECT
 VICE PRESIDENT
 VICE PRESIDENT
 VICE PRESIDENT
 VICE PRESIDENT
 SECRETARY
 TREASURER
 EXECUTIVE DIRECTOR

NEW YORK STATE SOCIETY
 OF
 CERTIFIED PUBLIC ACCOUNTANTS
 600 THIRD AVENUE
 NEW YORK, NY 10016
 212 661-2020
 TELECOPIER 212 953-7246



June 16, 1987

Dear Mr. Treadway:

The accompanying is the Society's response to the Exposure Draft the Commission released in May. We hope that our comments and recommendations will be helpful in the preparation of your final report.

If we can be of further assistance to you or your Commission, please let us know. A copy of our response has been sent under separate cover to each Commissioner.

Best regards.

Robert L. Gray, CPA
Executive Director

James C. Treadway, Jr., Chairman
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

RLG:am



THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

**RESPONSE
TO THE REPORT OF
THE NATIONAL COMMISSION ON
FRAUDULENT FINANCIAL
REPORTING**

JUNE 1987

PREFACE

The New York State Society of Certified Public Accountants is pleased to submit comments on the April 1987 Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting. We want to commend the Commission for presenting its views in a concise manner, and on a timely basis. We are in overall agreement with the recommendations, taken as a whole, as they were intended. However, we do wish to submit comments for your consideration in specific areas in which we either do not agree or believe a modification would enhance the recommendation.

Our Society is composed of over 29,000 certified public accountants, 65 percent of whom are involved in some level of public accounting or auditing practice and 30 percent of whom work in government or industry as internal auditors, financial executives, general executives, etc. (The remaining five percent of our membership is comprised of retired CPAs.) Accordingly, our comments will be limited to areas within our sphere of expertise, which encompasses all of the areas in your report with the exception of the regulatory and legal environment.

This document was prepared by a special task force of the Society and represents the views of our membership at large. The format, for your convenience, follows that of your Exposure Draft. The italicized material, taken directly from the Commission's complete set of recommendations, is followed immediately by Society comment and recommendation, if any, in print. An absence of editorial comment following a recommendation may be considered an indication of general agreement.

Task Force Members

J. Roger Donohue, CPA

Marilyn A. Pendergast, CPA

Robert L. Gray, CPA

Martin Rotheim, CPA

Richard J. Guiltinan, CPA, Chairman

COMMENTARY ON SPECIFIC RECOMMENDATIONS

Chapter One: Overview of the Financial Reporting System and Fraudulent Financial Reporting

No recommendations

Accordingly, we do not have any comments pertaining to the overview of the system.

Chapter Two: Recommendations for the Public Company

The Tone at the Top

Recommendation: For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

Recommendation: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

Recommendation: Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. A company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.

We concur in your belief that the corporate environment and the personal example set by top management are both fundamental to honest, ethical business practice. It follows that a "framework" of measures to establish and support such an environment is a very positive step, and we agree with your recommendations in this area.

Accounting Function and Chief Accounting Officer

Recommendation: Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.

We would anticipate much interest and commentary in this area from members of the Financial Executive, Management Accounting and Internal Audit communities. Many of our members work in such capacities within industry and would wholeheartedly support your recommendations in these areas.

The choice of a Chief Accounting Officer and his adherence to corporate and professional codes of conduct are both important factors in preventing and detecting fraudulent financial reporting. The tone set by such a Chief Officer and the example he sets will filter down and be emulated throughout the organization.

Internal Audit Function and Chief Internal Auditor

Recommendation: Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.

A strong and objective internal audit organization, well supervised, supported by top management, and adhering to professional standards established by the Institute of Internal Auditors is a critical link in the system of any company of reasonable size. It should be a requirement for all public companies other than those whose size would make it impracticable.

Recommendation: *Public companies should ensure that their internal audit functions are objective.*

It should be noted that in very large corporations a central or corporate audit staff may be unable to develop the necessary working knowledge of the subsidiary organizations to be fully objective. In such a situation, a strong relationship between central and subsidiary internal audit groups should be fostered. It may also be helpful to the maintenance of objectivity, if the internal auditors are assured of career path opportunities through a management supported program to place them in operations management positions at an appropriate point in their development.

Recommendation: *Internal auditors should consider the implications of their nonfinancial audit findings for the company's financial statements.*

We recognize that the internal auditor's responsibilities often go well beyond financial auditing, and agree that all findings may have implications for the financial statements and should be so considered.

Recommendation: *Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.*

We agree that the internal auditor should be fully involved in the audit of the financial reporting process and that his work should be coordinated with the independent auditor to help prevent and detect fraudulent financial reporting, as well as to avoid unnecessary overlap of responsibilities.

Mandatory Independent Audit Committee

Recommendation: *The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.*

We agree and suggest that the independent audit committee members must have experience and be knowledgeable in auditing, internal control, and/or corporate financial reporting responsibilities. A majority of them should be certified public accountants, if practicable.

Excellent potential sources of audit committee members are CPAs in industry, such as chief financial officers, and retired or other CPAs. However, some relief from financial risk is required (see below).

Recommendation: *Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.*

To insure the independence of the audit committee, the company's board of directors should require a signed affidavit of compliance with the Code of Professional Conduct and standards for independent directors to be filed by its members. Its purpose would be to assure the board of each individual audit committee member's objectivity. The board should periodically perform a review of the statements.

In order to attract qualified individuals who are willing to make the kind of time and effort commitment required, the audit committee members should be adequately compensated, and should also be assured of reasonable protection from liability (except for acts of gross negligence or intentional harm). This may require both federal and state legislation; unless such protection is provided, the goal of effective audit committees may never be fully achieved.

Recommendation: *All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it at least annually, and modify it as necessary.*

Recommendation: *Audit committees should have adequate resources and authority to discharge their responsibilities.*

In order to properly discharge its responsibilities, an audit committee may, at times, find it necessary to hire attorneys, actuaries, or other consultants or to expend reasonable sums to achieve its goals and objectives. Amounts expended above a certain minimum level should have to be approved by the board of directors or its chairman.

Recommendation: *The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.*

We agree that the audit committee should be totally familiar with all facts relating to the outside auditor's independence. To help insure that the auditors are totally independent in fact and in appearance, their selection should be approved by the audit committee.

Recommendation: *The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.*

We **strongly disagree** with the idea of the audit committee approving each non-audit use of the auditor's professional services. The audit committee is not in the best position to select an appropriate consulting firm for a specific non-audit task. Further, there has never been any indication that the extent of non-audit services has effected the independence of an outside auditor. To the contrary, broader exposure may be very beneficial to the auditor in performing his work.

Reporting on Responsibilities in the Annual Report to Stockholders

Recommendation: *All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.*

Recommendation: *All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.*

Seeking a Second Opinion

Recommendation: *Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.*

Recommendation: *When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.*

We agree in general with the recommendation, but suggest that the three year requirement be shortened somewhat. As an overall comment relating to audit committees, it may be impractical for smaller public companies to have a sufficiently large audit committee to do all the work that has been outlined.

Quarterly Reporting

Recommendation: *Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.*

Setting Standards for Internal Control

***Recommendation:** The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.*

We agree that much effective research has been done on the subject of internal controls by a variety of organizations over an extended period of time. We also recognize that valid differences of opinion exist over what constitutes effective internal control. An interdisciplinary approach to the matter might help resolve such differences, and we concur with the recommendation.

Chapter Three: Recommendations for the Independent Public Accountant

Recognizing Responsibility for Detecting Fraudulent Financial Reporting

Recommendation: The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.

Improving Detection Capabilities

Recommendation: The Auditing Standards Board should establish standards to require independent public accountants to perform analytical review procedures in all audit engagements and should provide improved guidance on the appropriate use of these procedures.

Recommendation: The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.

Improving Audit Quality

Recommendation: The AICPA's SEC Practice Section should strengthen its peer review program by increasing review of audit engagements involving public company clients new to a firm. For each office selected for peer review, the first audit of all such new clients should be reviewed.

First year audit clients are normally subject to the most comprehensive quality control review by any accounting firm. The procedures involved vary from firm to firm but usually include discussions with prior accountants and review of their workpapers; acceptance of a new client by the audit firm's own audit committee, director of audit, managing partner or equivalent; as well as a more extensive review of the initial report and workpapers by the engagement partner and the review partner. Since such procedures are normally imposed, we cannot understand why the Commission recommends that in the peer review program involving public company clients new to a firm, all such engagements must undergo an additional peer review. As an alternative to this recommendation, first year audits should be the population from which a sample is selected for review.

Recommendation: The AICPA's SEC Practice Section requirement for a concurring, or second partner review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.

The requirement of a concurring or second partner review of the audit report is cumbersome and inefficient.

Although we do concur with a second partner review, we do not find it beneficial in the planning stages. The engagement partner is involved in the planning stage of the audit in addition to numerous other qualified CPA's at the managerial or supervisory level. In larger engagements, there may also be more than one audit partner involved. If anything, the second partner should merely review what elements went into the planning process.

By having the review partner involved in the final review stage only, an objective independent view is brought to bear on the audit process. Furthermore, if the review partner was involved in the planning stages, not only would additional time burdens and cost be created, but the process would be lengthened and complicated without necessarily enhancing the quality of the engagement.

Mandating that the concurring review partner must have prior experience with both the audits of SEC registrants and a particular industry is cumbersome for the small and medium-sized accounting firms. These firms, although limited in number of partners, may have a partner with an expertise in a particular industry that would prove invaluable to the audit process. Because of firm size, another partner with industry expertise may not be available. Nonetheless, the partner that would be performing the concurring review may be as competent an audit partner of equal stature who would offer an objective insight and overview of the engagement.

We do realize that in some industries, complexity requires specific expertise. In such cases, the general auditing standards preclude a firm from undertaking the engagement.

Recommendation: Public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality.

Communicating the Auditor's Role

Recommendation: The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.

The Auditing Standards Board recently issued an exposure draft of a revised auditor's report which addresses this issue. The proposed report contains language regarding the auditor's role as it pertains to material misstatements as a result of fraud or error.

This revised report addresses the Commission's concern in this area, and will result in more informative financial statements for users, if adopted.

Recommendation: The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.

It is true that it is possible for auditors to improve the communication of their role to financial statement users. Currently, initiatives are underway by the Auditing Standards Board and others to help accomplish this objective.

However, we strongly oppose the revision of the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. We believe that such a report presents an implied opinion on internal controls, is inconsistent with attestation standards, and will be misunderstood by the readers of the report.

Further, we believe that disagreements with management's assessment of controls should not occur within the report itself, but must be eliminated prior to its issuance.

Current standards provide for reporting on internal accounting controls by means of a management letter. In many instances, particularly those involving small companies, effective internal controls is an impractical objective to meet.

Revision of the auditor's report to allow for all of the various possible internal control deviations would be ineffective in design and impractical in implementation.

Internal control encompasses too many factors to be discussed in-depth in the auditor's report. A summary of internal control findings would not provide the comprehensive information to meet the intention of this recommendation.

As a matter of practice, financial statement users may currently request a copy of the management letter which provides them with the auditor's findings and recommendations.

Reorganization of the Auditing Standards Board

Recommendation: *The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice.*

If it is necessary to reorganize the Auditing Standards Board, it should be done in such a way as not to disrupt an already successful operation. To this end, we recommend that three persons who are either not CPAs or CPAs no longer in public practice be added to the Board to provide the desired viewpoint that the Commission considers lacking, thus raising the number of Board members to 24.

Chapter Four: Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment

As previously mentioned in the preface to this response, the regulatory and legal environment is out of our sphere of experience. For this reason, we do not have any comment or recommendation to make in this section.

Additional SEC Enforcement Remedies

Recommendation: The SEC should have the authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding.

Recommendation: The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.

Recommendation: The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company.

Increased Criminal Prosecution

Recommendation: Criminal prosecution of fraudulent financial reporting cases should be made a higher priority. The SEC should conduct an affirmative program to promote increased criminal prosecution of fraudulent financial reporting cases by educating and assisting government officials with criminal prosecution powers.

Improved Regulation of the Public Accounting Profession

Recommendation: The SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SECPS of the AICPA's Division for CPA Firms.

Recommendation: The SEC should take enforcement action when a public accounting firm fails to remedy deficiencies cited in the public accounting profession's quality assurance program.

SEC Resources

Recommendation: The SEC must be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting.

Financial Institution Regulatory Agencies

Recommendation: *The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board (including the Federal Savings and Loan Insurance Corporation) should adopt measures patterned on the Commission's recommendations directed to the SEC to carry out their own regulatory responsibility relating to financial reporting under the federal securities laws.*

Recommendation: *The financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant.*

Enhanced Enforcement by State Boards of Accountancy

Recommendation: *State boards of accountancy should implement positive enforcement programs that periodically would review the quality of services that the independent public accountants they license render.*

Considering the Implications of Liability on Audit Quality

Recommendation: *Parties charged with responding to various tort reform initiatives should consider the implications that the perceived liability crisis holds for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting.*

Reconsidering Corporate Indemnification

Recommendation: *The SEC should reconsider its long-standing position that the corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable.*

Chapter Five: Recommendations for Education

Business and Accounting Curricula

Recommendation: Throughout the business and accounting curricula, educators should foster knowledge and understanding of the factors that may cause fraudulent financial reporting and the strategies that can lead to a reduction in its incidence.

Recommendation: The business and accounting curricula should promote a better understanding of the function and the importance of internal controls, including the control environment, in preventing, detecting, and deterring fraudulent financial reporting.

Recommendation: Business and accounting students should be well-informed about the regulation and enforcement activities by which government and private bodies safeguard the financial reporting system and thereby protect the public interest.

Recommendation: The business and accounting curricula should help students develop stronger analytical, problem solving, and judgment skills to help prevent, detect, and deter fraudulent financial reporting when they become participants in the financial reporting process.

Recommendation: The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting.

Recommendation: Business schools should encourage business and accounting faculty to develop their own personal competence as well as classroom materials for conveying information, skills, and ethical values that can help prevent, detect, and deter fraudulent financial reporting.

Taken as a whole, we strongly support the recommendations for education which would integrate in college curricula ethics and skills for reducing the instances of fraudulent financial reporting.

Although the Commission decided that the following did not fall under the purview of its study, we strongly affirm that the AICPA should adopt the 150-hour postbaccalaureate education requirement as a condition for membership for those entering the profession after the year 2000.

Professional Certification Examinations

Recommendation: Professional certification examinations should test students on the information, skills, and ethical values that further the understanding of fraudulent financial reporting and that promote its reduction.

Continuing Professional Education

Recommendation: As part of their continuing professional education, independent public accountants, internal auditors, and corporate accountants should study the forces and opportunities that contribute to fraudulent financial reporting, the risk factors that may indicate its occurrence, and the relevant ethical and technical standards.

KANSAS CITY POWER & LIGHT COMPANY

1330 BALTIMORE AVENUE

P. O. BOX 679

KANSAS CITY, MISSOURI 64141

June 16, 1987

NEIL ROADMAN
CONTROLLER

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Dear Commission:

The April 1987 Exposure Draft issued by this Commission has generated the need for a response from Kansas City Power & Light (KCPL). The Exposure Draft includes three points of interest that we believe we need to address. Those points of interest are as follows:

1. The audit committee should increase its oversight of the quarterly reporting process, including approval of financial results before their release to the public.
2. Independent accountants should be required by the SEC to review the quarterly financial data of public companies prior to its release to the public.
3. SEC should reconsider its long-standing position that corporate indemnification of directors for securities law liabilities is against public policy, and therefore unenforceable.

In regards to point one, this change would require incurring additional cost and hamper the timely release of quarterly financial results. One must keep in mind that financial statements normally receive a thorough review by various levels of management before release, which in our opinion is an adequate review. It is a fair assumption that only a very small percent of the total quarterly financial statements released to the public are ever presented in a fraudulent manner. Thus, it may be appropriate to implement these requirements only for quarterly financial statements that include unusual or extraordinary items (i.e., mergers, acquisitions, write-offs, etc). Furthermore, in most cases most audit committees review the annual report prior to release. This review should be made mandatory for all companies.

The second point listed above on the surface seems quite logical. However, the expense and hardship associated with the procedure would be quite burdensome. Not only would companies be required to pay external auditors for their review but may also be required to hire additional personnel in order to prepare certain schedules for the external auditors quarterly review. These schedules would be required to be prepared when there is already significant time constraints on Company personnel to prepare the financial data. As we mentioned in our discussion of point one, it may also be appropriate for this

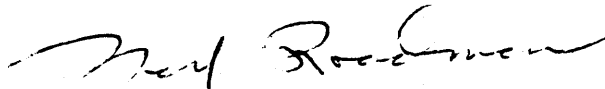
Commission to recommend implementing quarterly reviews, by independent accountants only if unusual or extraordinary items exists.

The third and final point of interest is concerned with corporate indemnification of directors. KCPL agrees with the Commission that the SEC should reconsider its long-standing position that corporate indemnification of directors for securities law liabilities is against public policy, and therefore unenforceable.

In conclusion, this Commission should not recommend unreasonable burdens on all public companies just because of the existence of a few fraudulent financial statements. Regardless of the new measures discussed in your exposure draft, the complete elimination of fraudulent financial statements will not occur.

Thank you for taking the time to consider our comments in this regard.

Sincerely,



GENERAL ELECTRIC

GENERAL ELECTRIC COMPANY
3135 EASTON TURNPIKE
FAIRFIELD, CONNECTICUT 06431

DENNIS D. DAMMERMAN
SENIOR VICE PRESIDENT-FINANCE

June 16, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Ave. N.W.
Washington, D.C. 20006

Gentlemen:

GE appreciates the opportunity to comment on the April 1987 Exposure Draft of the Commission's Report.

We believe the Commission has performed a valuable public service in its research, conclusions, and recommendations as set forth in the Draft. As the Commission recognizes, many of the recommendations, particularly those pertaining to public companies, would consist of extending good practices currently in effect among many firms. Nevertheless, there is considerable merit in cataloging, codifying, and publicizing such practices, and we hope that the Commission's prominence, and the leverage of its sponsoring organizations, will result in acceptance of most of the Commission's recommendations.

GE's philosophy and practices are quite consistent with most of the recommendations of the section of the Exposure Draft directed to public companies. We will, of course, review the final Report in detail and evaluate what changes, if any, might be appropriate and under our own control.

Before issuing the final report, however, there is one area to which we suggest the Commission gives more consideration, namely, sharpening the distinction between the Audit Committee's oversight role, which we agree with the Commission is extremely important, and the operating role of management. The Audit Committee Good Practice Guidelines (Appendix K of the Report) and most of the specific recommendations regarding Audit Committees appear to us to be expressive of the oversight function. However, we are concerned about the characterization of the Audit Committee as "the primary (emphasis added) vehicle that the Board of Directors uses to discharge its responsibility with respect to the company's financial reporting". While the Audit Committee certainly has the important role of overseeing the financial reporting process, it should not have the primary responsibility — that is and should be the responsibility of a company's management, employees and independent public accountants.

25a

Also, the recommendation that the Audit Committee approve quarterly financial results prior to public release blurs the distinction between oversight and operations and may not be practical in some cases. We endorse the notion that the Audit Committee should exercise oversight of the quarterly reporting process. Oversight of the process should be encouraged, chiefly by good ongoing communications between management, internal and external auditors, and the Audit Committee. For example, quarterly results of most public companies are reviewed by public accountants prior to release even though a formal report of the review may not be disclosed. Any concerns arising from these reviews are or can be communicated to the Audit Committee, and that Committee can or should satisfy itself as to the results of those reviews. Good communications also should ensure that the Audit Committee and the Board are not "surprised" either as to amount or causes of interim results. However, depending on operating schedules, a requirement for an Audit Committee meeting to review actual results and a press release draft prior to issuance may not be feasible without substantially delaying public release of data. We believe the Audit Committee can fulfill its oversight of the quarterly reporting process without having to act formally on specific interim press releases.

In conclusion, we reiterate our support for the Commission and look forward to early publication of its final Report and the positive effects on financial reporting which we believe the Report will have.

Very truly yours,



D. D. Dammerman

:als

cc: J. F. Welch
L. A. Bossidy
E. E. Hood
Audit Committee of the
GE Board of Directors

MELVIN L. HIRSCH

ATTORNEY AT LAW
60 EAST 42ND STREET
NEW YORK, NEW YORK 10165
TELEPHONE (212) 697-4885

June 18, 1987

The National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

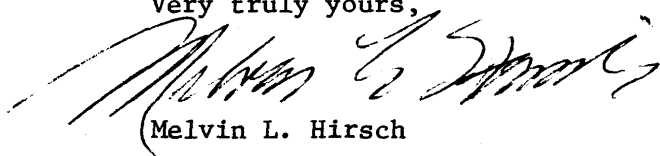
Gentlemen:

I have received from Ernst & Whinney their Exposure Draft - April 1987 of your Report.

I am a director of two public companies and a practicing attorney for over thirty-five years.

I disagree with the suggestion that the SEC should reconsider its position that corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable. It is my experience that this provision of the law acts as a deterrent to corporate wrongdoing. The only directors that would be opposed to the continuation of this provision are those who are not willing to take the time and effort to review management and corporate proposals.

Very truly yours,



Melvin L. Hirsch

MLH:jb



UNITED-GUARDIAN, Inc.

Corporate Divisions and Subsidiaries

UNITED RESEARCH
GUARDIAN CHEMICAL
EASTERN CHEMICAL
CONSOLIDATED ASTRONAUTICS, INC.

MAILING ADDRESS:
P.O. BOX 2500
SMITHTOWN, NY 11787
CORPORATE HEADQUARTERS
AND MAIN PLANT:
230 MARCUS BLVD.
HAUPPAUGE, NY 11788
TEL.: (516) 273-0900
TWX: 510-227-6230

June 18, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Ave, NW
Washington, DC 20006

Gentlemen:

With respect to the Report of the National Commission on Fraudulent Reporting exposure draft of April, 1987, there is no question that the study is complete and the recommendations worthwhile. There is, however, no analysis of the cost involved.

For many small and startup public companies, with thin budgets and managements, the need to comply with the recommendations will be relatively expensive and most burdensome.

I would strongly recommend that the Commission, (a) provide some estimates of the cost of compliance; (b) examine the concept of stratification by size or number of shareholders or age of the business to permit a phasing in of the recommendations according to a firm's ability to bear the incremental financial burden.

Sincerely,
UNITED GUARDIAN, Inc.

Stanley S. Fine
Senior Vice President

SSF;bw

DynCorp

1313 Dolley Madison Boulevard
McLean, Virginia 22101-3980
(703) 356-0480

87-098
June 18, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

I have read with interest the exposure draft of the Commission's report. Overall, I commend the Commission for essentially accomplishing its goals and objectives. On balance, I found the recommendations to be refreshingly practical and reasonable.

I would like to comment on one specific recommendation, despite the Commission's warning that it is inappropriate to single out one recommendation from the totality. My concern is that, under existing procedures, the requirement for independent public accountants to review quarterly financial data before release to the public will result in additional costs which exceed the benefits to be derived. I believe it is preferable that involvement of independent public accountants with quarterly financial data be left to the discretion of the audit committee. However, if the Commission believes that this recommendation is essential as an integral part of the whole, then I respectfully request that the Commission consider a related recommendation which would require the AICPA to revise its professional standards with respect to the review of interim financial information to permit more flexibility and allow the independent public accountant to apply procedures which are specifically appropriate for a company being reviewed.

The following points present my arguments in support of the preceding request.

1. The Commission has recommended that independent audit committees approve quarterly financial data prior to release. In describing the duties and responsibilities of an effective audit committee, the Commission has published guidelines, establishing an overall framework as opposed to a series of specific requirements. It would be within the spirit of this approach to leave it to

the discretion of an audit committee as to whether the independent public accountants should be engaged to review quarterly financial data and, if so, to specify the extent of the desired review.

- 2. As mentioned, the Commission has refrained from requiring detailed procedures but rather has attempted to establish frameworks. However, a requirement for the involvement of independent public accountants with quarterly financial data is, under existing accounting literature, a departure from this approach. Despite the fact that a review of interim financial information produces a disclaimer of an opinion and only "negative assurance," the accountant essentially is required to perform at least the specific procedures spelled out by the AICPA. In a company which has demonstrated good controls over interim financial reporting, much of the work performed quarterly by the independent public accountants under their obligatory procedures could be to satisfy form, with little substantive value.
- 3. The Commission has recommended that the auditor assess the risks of fraudulent financial reporting and consider such assessment in establishing the audit plan. It would seem that this recommendation should apply if the independent public accountants are to be required to review quarterly financial data. Under present literature, as applied by the profession, I question whether there is sufficient flexibility to adapt the procedures to the assessed risks, and particularly whether there is leeway to omit some of the specified procedures when the assessment is that there is no related risk.
- 4. If the SEC adopts the Commission's recommendation, it is a virtual certainty that registrants will be required to include reports

from their independent public accountants in quarterly 10-Q filings. The need for a report, even though no opinion is expressed, in effect forces the public accountant to perform the procedures stipulated in the professional literature.

5. An auditor with continuing client involvement is aware of the substantive financial reporting issues. Absent the need to apply universal standard procedures and absent the need to issue a quarterly "nonopinion" to the public, the auditor can work with the audit committee to apply audit procedures which truly are appropriate in the circumstances, thereby helping to improve the quality of interim financial reporting at a reasonable cost.
6. It is recognized that the Commission has recommended that the Auditing Standards Board ("ASB") be reorganized to broaden its representation. It may be that the Commission believes that a reorganized ASB can deal effectively with the concern expressed herein. However, as a practical matter, it is possible that the SEC will adopt the Commission's recommendation in the near term but that the AICPA will be slower to react. Also, it may be years before a reorganized ASB gets to the issue of interim financial reporting. Accordingly, several years could pass with required independent public accountant review of quarterly financial data under existing inflexible professional standards.

I appreciate this opportunity to comment on the Commission's report.

Very truly yours,



Robert G. Wilson
Vice President and
General Auditor

Palm Desert National Bank



June 18, 1987

The National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Gentlemen:

I have just finished a review of the Exposure Draft for the Report of the National Commission on Fraudulent Financial Reporting presented by Ernst & Whinney.

The document appears to cover all of the salient points needed for a public company to establish the necessary audit and control measures.

My question and/or recommendation is of a different nature and is explained as such. Small banks, such as mine, and other companies small in nature generally do not have the necessary time, general writing skill or internal disciplines to prepare the needed written policies and procedures to follow for compliance.

It would seem to me that the very people who write these regulations, guidelines and recommendations would do well for our small companies, by including a generic set of written policies and procedures for us to implement and follow.

Thank you for your time and consideration of my suggestion.

Sincerely,

William T. Powers
President and
Chief Executive Officer

WTP:dk



Central and South West Services, Inc.

2121 San Jacinto Street • Suite 2500
 P.O. BOX 660164 • Dallas, Texas 75266
 214-754-1248

PHILLIP J. KASTER
 Director of Audits

June 18, 1987

National Commission on Fraudulent
 Financial Reporting
 1701 Pennsylvania Avenue, N.W.
 Washington, D. C. 20006

Gentlemen:

I have read with interest your draft report and would like to make the following comments:

The recommendation that audit committees approve quarterly financial results prior to their release poses several difficulties. The logistics required of our outside directors to meet and review these statements would prove to be extremely difficult to accomplish. Our outside directors are very busy businessmen and finding a mutually agreeable time to meet in addition to regular board meetings could prove to be very onerous. I would like to believe that the internal controls in existence at our company would prevent any "surprises" or misstatements from publication and release. There has not been a change required in our quarterly financial statements due to omission, error or misstatement in my memory. In addition this requirement would most likely cause a substantial delay in the issuance of quarterly statements which could prove to be unacceptable to the financial community who rely on our accurate and timely reporting.

The recommendation that approval in advance, with the types and extent of management advisory services to be performed by the independent public accountants is a resurrection of an SEC requirement which has been rescinded. Again, I firmly believe that the outside accountants annual report to our board and audit committee of all services rendered permits them the overview necessary to determine whether their independence has been compromised. We have had no occasion to limit our outside accountants' involvement in MAS projects due to any potential independence issue. In fact the knowledge of our outside accountants of our industry and business allows them to perform very valuable services which would most likely cost more if performed by others.

I thank you for the opportunity for commenting on your substantial effort in providing the investing public with more accurate financial data.

Sincerely,

A Member of the Central and South West System

Central Power and Light Company • Public Service Company of Oklahoma • Southwestern Electric Power Company • West Texas Utilities Company
 Transok, Inc. • Central and South West Fuels, Inc.



June 18, 1987

The National Commission on Fraudulent
 Financial Reporting
 1701 Pennsylvania Ave. N.W.
 Washington, D.C. 20006

Dear Sirs:

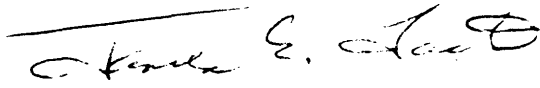
I have just finished reading an overview of your recommendations on fraudulent financial reporting. It appears that, as per usual, you fail to take into account the numerous small public companies struggling to stay in existence. Many of these companies have a very small accounting staff. As you well know, it is very difficult to have effective internal control when the entire accounting staff consists of two or three people. I see nothing in you recommendation concerning this problem.

It also appears to me that you are also going to push the cost of audits of small companies completely out of sight. First you would require review of quarterly financial statements before they could be released to the public. Next you advocate increasing the scope of the audit to include tests for fraud. You would have the independent auditor revise their report to include language clarifying the auditors responsibility for fraud detection. If I am not mistaken, this opens the auditor up to potential lawsuits for nondetection of fraud. This will probably increase the cost of his malpractice insurance. The last time I looked, auditors did not work for free. You would have the client pay for additional review services, increased audit scope, and for the increase in the auditors malpractice insurance. Speaking from a small company's viewpoint, I don't see the benefit. I would much rather put our limited funds to work for the shareholder rather than have them go to the independent auditor. We currently use a "Big Eight" accounting firm. If your recommendations go into effect, we will no longer be able to afford their services. We will then have to go to a less desirable, from our viewpoint, firm in order to be able to comply with all of your recommendations. This does not sound like a policy that will benefit our shareholders.

I would ask that you reconsider your recommendation and take into account that not every public company has a large accounting staff, internal audit staff, or significant sums of money to pay independent auditors. I recognize that there is a problem with fraudulent reporting. I do not believe however, that throwing money at the problem will make it go away. It appears to me that you have not acted, you have over-reacted.

Yours truly,

NOVA NATURAL RESOURCES CORPORATION



James E. Taets
Vice President/Finance

JET/rfs

**HOUSEHOLD
INTERNATIONAL**

June 18, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sirs:

On behalf of the members of the Audit Committee of Household International, I am pleased to respond to the April, 1987 Exposure Draft of the Commission's report on Fraudulent Financial Reporting. Our members include Mary Johnston Evans, Dennis C. Fill, and Gordon P. Osler. Our principal occupations and business associations are summarized in Exhibit 1.

As Directors and members of an audit committee, we share the Commission's concerns. We are pleased that you have undertaken this effort to identify causal factors that can lead to fraudulent financial reporting and, most importantly, to identify steps that can help reduce the incidence of such reporting. Your draft is an excellent step in the right direction and we broadly support most of your recommendations concerning the role of the audit committee.

In carrying out our responsibilities at Household International, we believe we conform in all material respects with the guidelines and procedures set forth in Chapter 2 and Appendix K. Certain of your recommendations require response in view of our concern that literal applications may unnecessarily burden audit committees and do little to further your basic objective of prevention and detection of fraudulent financial reporting.

Advance Approval of MAS Services

We are quite aware of the debate regarding the possibility that management advisory services offered by independent public accountants might impair their independence but, in practice, have seen no evidence to support these concerns. We believe the Commission's final report should clearly accept practices where audit committees establish as a matter of policy the types and general order of magnitude of management advisory services that can be obtained from independent auditors without advance approval and the types of services that are proscribed unless advance approval is obtained. We believe advance approval should be

required for specific services only in situations where the magnitude of such services exceed guidelines set by our committee or include the type of services which are proscribed in the audit committee approved policy. We are satisfied that, with this type of policy in effect, after-the-fact reporting of MAS services is sufficient to enable us to confirm that external auditors remain independent.

Audit Committee Chairman's Letter

We strongly disagree with the idea of including in annual reports to shareholders a letter from the chairman of the audit committee describing the committee's responsibilities and activities. Household's annual report includes reports by our external auditors and our management. Our committee's role, as well as that of other committees of the Board, is described in Household's annual report in summary fashion (See Exhibits 2 and 3). To expand discussion of our role raises serious issues relating to assumption of additional legal responsibilities, unreasonably highlights our role above that of other committees and the Board as a whole, and adds more verbage to the annual report without substantively increasing efforts to prevent and detect fraudulent financial reporting.

Quarterly Reporting Process

A recent research project completed by SRI, International for the Financial Executives Research Foundation indicates that investors in public companies rely on the following sources of information (listed in order of importance):

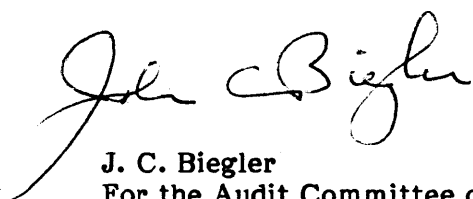
- Annual reports
- Newspapers including Wall Street Journal
- Brokers
- General business publications
- Personal contacts
- Quarterly reports
- SEC filings and prospectus
- Investment information services
- Brokerage firm analyses and reports

Quarterly reports issued by public companies indeed are important but are only one of several important sources of financial information. Asking audit committees to get in front of the financial communication process by reviewing quarterly results prior to releasing data to the public is, in our opinion, clearly inappropriate. We cannot adequately review interim financial reports before they are issued without slowing up release of these data. Our role in the quarterly reporting process should continue to be restricted to oversight. We urge, instead, that the Commission focus on an efficient process that involves senior external audit management in timely reviews of interim financial reports and limits the role of audit committees to receipt of written reports from external auditors describing their roles and conclusions and an annual discussion of the scope and general conclusions relating to adequacy and propriety of interim disclosures and related control processes.

Corporate Indemnification of Directors
for Securities Law Violations

We strongly concur with the Commission's suggestion that the SEC reconsider its long-standing position that corporate indemnification of directors for securities law liabilities is against public policy and therefore unenforceable. We recognize that the SEC's position is based on the view that indemnification of officers and directors for liabilities under the 1933 Act would be inconsistent with deterrent policies of the Securities Laws. The SEC policy, however, seems to be directed at those who committed sins graver than ordinary negligence. To illustrate, in Globus v. Law Research Services, Inc., the Second Circuit affirmed the District Court's findings that an underwriter who had actual knowledge of material misstatements in a registration statement could not recover indemnification from the issuer. We also point out that SEC changes in this area generally would be consistent with recent Delaware legislation which permits corporations to indemnify directors if they are not guilty of gross negligence. If we are to have strong, effective audit committees, we need an environment that does not discourage qualified candidates from accepting such responsibilities. This is especially important if we are to expand use of independent audit committees to the many business enterprises that presently do not have such functions or cannot recruit qualified independent directors for such roles.

Sincerely,



J. C. Biegler
For the Audit Committee of
Household International

GNL-0867

- cc: M. J. Evans
- D. C. Fill
- G. P. Osler
- D. C. Clark
- G. N. Larson

Exhibit I

Audit Committee of Household International**Business Associations****John C. Biegler**

Mr. Biegler retired as Chairman of the public accounting firm of Price Waterhouse in 1982, having been with the firm since 1946.

Mary Johnston Evans

Mrs. Evans is a director of CertainTeed Corporation, Delta Air Lines, Inc., Baxter Travenol Laboratories, and Sun Company, Inc. She is a member of the Advisory Board of Morgan Stanley & Co., Inc. and a trustee of several investment trusts of the American Association of Retired Persons. She served as Vice Chairman of the Board of the National Railroad Passenger Corporation (AMTRAK) from 1974 to 1979.

Dennis C. Fill

Mr. Fill is Chairman and Chief Executive Officer of Westmark International, Inc. (medical electronics equipment). Mr. Fill was appointed to his present position following Westmark's spin-off from Squibb Corporation in 1986. Mr. Fill had been President and Chief Operating Officer of Squibb Corporation, a maker of pharmaceuticals, medical, and personal health care products. He also is a director of Morton-Thiokol, Inc.

Gordon P. Osler

Mr. Osler is Chairman of TransCanada Pipelines Limited. He served as Chairman of Stanton Pipes Limited from 1979 to 1986. Mr. Osler also is Chairman of the Board of the North American Life Assurance Company and a director of Toronto Dominion Bank and Maclean-Hunter Limited.

Arthur E. Rasmussen

Mr. Rasmussen, as Chairman of the Executive Committee, is an ex officio member of the Audit Committee. He retired in 1974 as Household's Chief Executive Officer and Chairman of the Board. He also is a director of Central and South West Corp., Amoco Corporation, and Abbott Laboratories.

Management's Report

To the Shareholders of Household International, Inc.

Management is responsible for the preparation, integrity and objectivity of the company's financial statements. Such statements are prepared from the company's books and records of transactions recorded in the ordinary course of business and include amounts that are based upon management's best estimates and judgments, all in conformity with generally accepted accounting principles. Financial information included elsewhere in the annual report is consistent with that in the financial statements.

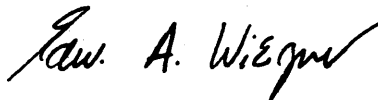
The company maintains systems of internal accounting controls and procedures which management believes provide reasonable assurance that financial records are reliable for preparing financial statements and maintaining accountability for assets. Internal auditors evaluate the adequacy of and investigate adherence to these controls and procedures. Independent auditors also study and evaluate the company's accounting systems and related controls and perform tests of transactions and account balances in accordance with generally accepted auditing standards. This permits them to render an opinion as to the fairness of the company's financial statements.

The Audit Committee of the Board of Directors is composed solely of outside directors. It meets periodically with independent auditors, internal auditors and management to discuss auditing and financial reporting matters. Both internal and independent auditors have unrestricted access to the Audit Committee without presence of company management to discuss results of their audit work and their opinions as to the adequacy of internal accounting controls and quality of financial reporting.

Management has long recognized its responsibility for conducting the Company's affairs in a manner which is responsive to the interests of employees, shareholders, investors and society in general. This responsibility is included in our statement of policy on ethical standards which provides that the company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards. Officers, employees and agents of the company are expected and directed to manage the business of the company with complete honesty, candor and integrity.



D.C. Clark
Chairman of the Board,
President and Chief Executive Officer



E.A. Wiegner
Senior Vice President and Chief Financial Officer



G.N. Larson
Group Vice President,
Controller and Chief Accounting Officer

Independent Auditors' Report

To the Shareholders of Household International, Inc.

We have examined the balance sheets of Household International, Inc. (a Delaware corporation) and subsidiaries as of December 31, 1986 and 1985 and the related statements of income, changes in other shareholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The statements of income, changes in other shareholders' equity and changes in financial position for year ended December 31, 1984 were examined by other auditors whose report thereon dated February 7, 1985 expressed an unqualified opinion on those statements.

In our opinion: the financial statements referred to above present fairly the financial position of Household International, Inc. and subsidiaries at December 31, 1986 and 1985 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of accounting for pensions as described in note 15 to the financial statements, were applied on a consistent basis.

Committees of the Board

Audit Committee

The Audit Committee reviews the corporation's internal controls, financial reporting practices, annual financial statements and the examinations made by internal and independent auditors. This committee consists entirely of non-management directors.

John C. Biegler, *Chairman*
Mary Johnston Evans
Dennis C. Fill
Gordon P. Osler

Finance Committee

The Finance Committee approves the issuance of securities by the corporation and its major subsidiaries and reviews dividend policy.

Gordon P. Osler, *Chairman*
John C. Biegler
Donald C. Clark
Gary G. Dillon
Joseph W. James
Lewis W. Lehr
George W. Rauch

Compensation Committee

The Compensation Committee determines the salaries, bonuses and stock options for senior management. This committee consists entirely of non-management directors.

Miller Upton, *Chairman*
Mary Johnston Evans
Dennis C. Fill
Lewis W. Lehr
Raymond C. Tower

Nominating Committee

The Nominating Committee recommends candidates for board membership, reviews board size and composition, recommends changes in board compensation, and reviews management succession and development plans.

Raymond C. Tower, *Chairman*
Donald C. Clark
Miller Upton

Executive Committee

During intervals between board meetings, the Executive Committee, with some exceptions, may act for the board.

Arthur E. Rasmussen, *Chairman*
Donald C. Clark
Gordon P. Osler
George W. Rauch
Miller Upton

Arthur E. Rasmussen, as Chairman of the Executive Committee, is also an ex officio member of the Audit, Compensation, Finance and Nominating Committees.



School of Accountancy

312 Middlebush
Columbia, Missouri 65211
Telephone (314) 882-4463

June 19, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

I am writing on behalf of the Accounting and Auditing Committee of the Missouri Society of Certified Public Accountants. We would like to comment on three aspects of the Exposure Draft of your findings, conclusions, and recommendations.

Role of the Audit Committee

We are concerned about your recommendations to expand the role of audit committees in the financial reporting process. Specifically, we are concerned that your recommendation to have audit committees approve interim financial reports prior to their public release would result in much more costly and less timely interim reporting. The related recommendation of requiring independent auditors to review interim financial reports would appear to be a sufficient expansion of procedures designed to assure the reliability of such financial data.

Effect on Small Companies

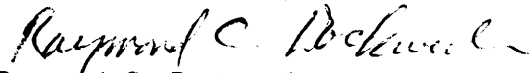
We are concerned about the extraordinary burden many of your recommendations may have on smaller companies. On the one hand, we agree with the sentiment that if companies, large or small, accept public funds, they must also accept public obligations. However, it should also be recognized that there will be much less impact on larger companies that already have implemented many of your recommendations than on smaller companies that have not. Consideration should be given to this reality, perhaps in the form of a transition period.

Recommendations for Education

We agree that education can have an important influence on the financial reporting system, and with your related recommendations for continued emphasis on liberal arts and for additional preparation or course work in accounting and systems, and in developing analytical reasoning skills and good ethical judgment; yet, you fail to recommend five-year or graduate education programs in accounting. This is an inconsistency that calls into question virtually all of your recommendations in the area of education. If indeed you mean what you say regarding the educational preparation required in today's financial reporting environment, then you must also recommend five-year or graduate education programs in accounting.

We appreciate the opportunity to comment on the Exposure Draft of your Report and, of course, hope that you will seriously consider our thoughts.

Sincerely,



Raymond C. Dockweiler

Other Committee Members:

Michael J. Grojean, Chairman
(Anders, Minkler & Diehl, St. Louis)

William D. Stout
(Monsanto, St. Louis)

Jerry D. Myers
(Donnelly, Meiners & Jordan,
Warrensburg)

Gregg W. Givens
(Price Waterhouse, Kansas City)

HILLENBRAND INDUSTRIES

June 19, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Gentlemen:

We support the spirit of your April, 1987 exposure draft and believe most of the concepts and implementation guidelines are reasonable. We offer the following comments.

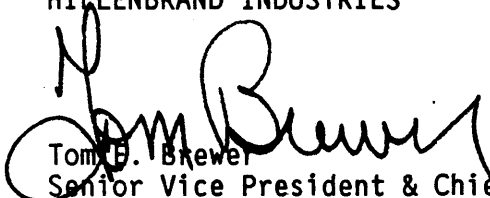
- We have a conceptual problem with whether the active involvement of the audit committee in the reporting process is appropriate or desirable. Recognizing that the audit committee should have an oversight function in reporting, it seems the recommendation to have the audit committee review quarterly financial statements on a pre-release basis takes the board members out of the direction setting and policy making role and puts them into daily operations. We understand the reasoning for this recommendation but feel it is an inappropriate involvement of board members in operating activities.
- The other comment is a request for clarification. You recommend the management responsibility for the financial statements report in the annual report be signed by the chief executive officer and the chief accounting officer. Our comment is that the financial signature should be either the chief financial officer's or the chief financial officer and the chief accounting officer. The chief financial officer is the financial member of management who has ultimate responsibility for the accuracy and fairness of the financial statements. An argument could be made to have the chief accounting officer also sign the report but our basic feeling is this second financial signature is redundant.

Overall, we applaud the draft recommendations. We feel they will have little impact on our company because we implemented most of the concepts some time ago.

If you have any questions, do not hesitate to contact me.

Sincerely yours,

HILLENBRAND INDUSTRIES



Tom E. Brewer
Senior Vice President & Chief Financial Officer

TEB:ljf
610

NATIONAL ASSOCIATION OF ACCOUNTANTS

10 Paragon Drive • Montvale, New Jersey 07645-1760

(201) 573-9000 • Telex 181-162

June 19, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sirs:

This letter is written by me in my personal capacity and does not represent the views of the National Association of Accountants.

The following comments refer to Chapter V on Education. Your recommendation on Continuing Professional Education could be strengthened by a recommendation that management accountants responsible for the preparation of corporate financial statements should be required to have some minimum amount of continuing professional education, say 30 or 40 hours each year. This education is presently widely available by a number of providers. I believe that NAA would be in a position to monitor the accumulation of those hours inasmuch as we have an existing computer program to maintain such records for current NAA members.

Your recommendation No. VI on Educational Initiatives by Public Companies is equally apt. NAA through its Accountants Television Network (ATV) provides approximately 100 firms today with video taped educational material. Each tape comes complete with a discussion leader outline. Current experience suggests that those companies using this type of material are able to focus the discussion of their professional accounting staff on topics of interest to that company, utilizing the professionally prepared educational material supplied by the Accountants Television Network. Obviously you cannot recommend a specific program, such as ATV, but you should encourage formal company sponsored programs.

I would recommend that the Commission in its final report reprint the Codes of Ethics of organizations such as the AICPA, FEI and NAA. This would be of help to readers, now and in the future -- if for nothing else than a handy reference source.

Finally, there seems to be an imbalance in the report. A lot of time is spent on the background and role of the Audit Committee, the Internal Auditors and the External Auditors. It is true the Chapter II deals with the responsibility of the public company for financial reporting. You do discuss the tone at the top, but you have less than one page on the Accounting Function and Chief Accounting Officer. I urge the Commission to expand the section under IIIA in Chapter II (currently page 32) to recommend that the background and training of the corporate financial staff meet certain minimum requirements. Additionally I think that it would be desirable for professional members of each company's accounting staff to belong to one of the major professional organizations, for example: AICPA, FEI, IIA or NAA. Organizations with a code of conduct can remove somebody from membership. Thus there would be at least some degree of private sector initiative in the process of providing discipline.

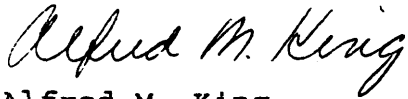
Whether you could go so far as to say that the financial officers signing the SEC reports must have some sort of certification, such as a CMA or CPA certificate, is an issue which may be too controversial. I personally would favor such a requirement because of the ability for the corresponding organization to withdraw the certification if the individual did not abide by the standards of ethical conduct and the mandatory continuing professional education requirements. Certainly some discussion of these issues should appear in your final report.

Since you are arguing that non-accountants should be on the Auditing Standards Board and the role of the internal auditor should be formalized it seems only appropriate to formalize the background requirements for those with the

primary responsibility for financial reporting, corporate financial officers and staff.

If you have questions on these points I would be very pleased to elaborate upon them, either in writing or in person.

Very truly yours,



Alfred M. King
Managing Director
Professional Services

AMK:vw

Public Service
Electric and Gas
Company

Parker C. Peterman
Vice President and Comptroller

80 Park Plaza, Newark, NJ 07101 201-430-6161 Mailing Address: P.O. Box 570, Newark, NJ 07101

June 19, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue
Washington, D.C. 20006

Dear Sirs:

Public Service Electric and Gas Company (PSE&G) is pleased to submit comments on the Commission's Exposure Draft entitled "Report of the National Commission on Fraudulent Financial Reporting". PSE&G is an operating public utility company in New Jersey providing electric and gas service to approximately 1.8 million electric customers and 1.4 million gas customers throughout the state. In 1986, our net income exceeded \$428 million on operating revenues of approximately \$4.5 billion.

PSE&G commends the efforts of the Commission, and supports the overall conclusion of the report that the responsibility for reliable financial reporting rests principally with top management, in that management sets the tone and establishes the reporting environment within which financial reporting occurs. Our Company has established and historically maintained practices and procedures which mirror many of the Commission's recommendations.

There are, however, a few recommendations with which we have some reservations.

PSE&G's specific comments on the Exposure Draft are as follows:

Mandatory Independent Audit Committees

We agree with the spirit of the recommendations, namely, that Audit Committee members be informed overseers of the financial reporting process. PSE&G's Audit Committee has historically functioned in much the same fashion as recommended by the Commission. We are concerned, however,

that the Commission's recommendations will be construed as elevating the Audit Committee to a level of responsibility higher than management, other committees of the Board of Directors, or the entire Board of Directors.

Seeking a Second Opinion

The recommendation that management advise the Audit Committee when it seeks a second opinion on a significant accounting issue should be restricted to written, formal opinions, as distinguished from a casual professional interaction.

The recommendation for disclosure of a change of independent auditors is a broader application of existing SEC regulations. We feel this recommendation should be limited to situations where a disagreement or difference of opinion exists between the new and old auditors. In general practice at our Company, the Audit Committee recommends appointment of independent auditors to the full Board of Directors and such appointment is approved by a vote of stockholders.

Quarterly Reporting

Approval of financial results by the Audit Committee would be redundant for companies such as ours where the financial results are presented monthly to the entire Board of Directors.

Additional SEC Enforcement Remedies

While it is true that any increase in fraud penalties and sanctions may appear to increase the deterrent effect on fraudulent activities, highly visible prosecution or enforcement activity under existing law would also achieve the desired deterrent effect.

With regard to the proposed "cease and desist orders", while initially such "remedy" may appear justified, it raises significant questions of:

- (1) Due process and procedural safeguards.
- (2) Whether there is any significant difference between the "likelihood of further violation" standard of the proposed cease and desist order and the existing injunctive power of the SEC.

- (3) Whether it is more reasonable for the standard-setting body (e.g. Financial Accounting Standards Board) to continuously review and revise its own standards to eliminate the "cute accounting" violations referred to on page 61 of the ED based on perceived ambiguities in the accounting standard, or to give authority to the SEC not only to interpret what the written standard says, but also what it ought to mean.

PSE&G appreciates the opportunity to present our views to the Commission, and to demonstrate our support of its efforts to reduce fraudulent financial reporting.

A handwritten signature in black ink, appearing to read "Robert L. Stinson", with a long horizontal flourish underneath.


TELE-COMMUNICATIONS, INC.

GENERAL OFFICES · 54 DENVER TECHNOLOGICAL CENTER · CALL BOX 22595
WELLSHIRE STATION · DENVER, COLORADO 80222 (303) 771-8200

June 22, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington D.C. 20006

RE: April, 1987 Exposure Draft

Dear Sirs:

This letter presents our views on the "Recommendations for the Public Company" set forth in Chapter Two of the Report of the National Commission on Fraudulent Financial Reporting (April, 1987 Exposure Draft).

While we are generally supportive of the efforts of the National Commission, we are concerned that the recommendation under the caption Quarterly Reporting, which suggests that the audit committee (presumably comprised solely of outside directors) be required to approve financial results prior to public release, may have an adverse effect on a public company's ability to report its results with the required 45-day period. In our opinion, the outside directors may not be in a position to judge the reasonableness of financial results and, therefore, should not be put in such a position. The audit committee should be more concerned with the adequacy of controls & procedures that protect the integrity of quarterly reporting than with the actual output (i.e., financial results) of the reporting system.

In addition, due to recent changes in the market for directors' liability insurance, it is becoming increasingly difficult to obtain & retain outside directors. This situation will almost certainly be aggravated by placing the responsibility for "underwriting" the quarterly financial results upon outside directors. If outside directors were put in the position of having to approve quarterly results, it would only be prudent for them to perform some measure of due diligence. This would take time and may cause a conflict with the 45-day filing requirement. The result would be either that the due diligence is reduced (or eliminated) and the director's approval is hollow or the filing is not made on a timely basis. We believe that either result is not in the public interest.

We respectfully submit that the final report of your commission should retain the recommendation that audit committees should increase their oversight of the quarterly reporting process but should drop the requirement that audit committees should approve quarterly financial results prior to public release.

Very truly yours,

TELE-COMMUNICATIONS, INC.

Gary K. Bracken, CPA
Vice President & Controller

David R. Humphrey, CPA
Director of Corporate Reporting

EDMUND W. LITTLEFIELD
550 CALIFORNIA STREET
SAN FRANCISCO, CALIFORNIA 94104

June 22, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C.

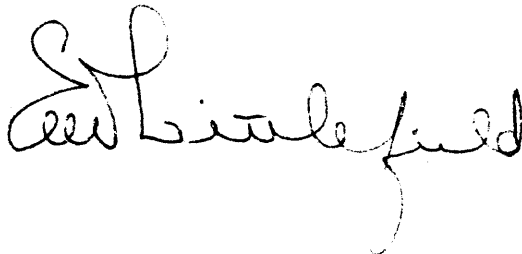
Gentlemen:

My attention has been drawn to the initial sentences in Appendix K regarding "Audit Committee Good Practice Guidelines."

I think that this is charging the Audit Committee with responsibility that it is in no position to handle without incurring a substantial change in the way it functions. It would have to arm itself with full-time skilled staff and time demands upon the outside directors would be so onerous that the best of them would be reluctant to serve.

It has been my experience that Audit Committees as now constituted, coupled with a strong internal audit group and competent independent certified public accountants, are doing a satisfactory job in almost every instance. The improvement in overall results that would be achieved by your proposals would come at too high a cost to justify the actions.

Very truly yours,



EWL/nf

STERLING DRUG INC.

NINETY PARK AVENUE, NEW YORK, N. Y. 10016

JOHN M. PIETRUSKI
CHAIRMAN OF THE BOARD
AND
CHIEF EXECUTIVE OFFICER

June 23, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Commission Members:

I have recently become aware of the preliminary report of the National Commission on Fraudulent Financial Reporting. Generally, the report is comprehensive and well done.

I would like to call your attention to one section, however, that should be corrected. The first two sentences contained in Appendix K on page 183 under the heading "Audit Committee Good Practice Guidelines," read as follows: "An audit committee consisting of independent directors is the primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting."

These two sentences overstate considerably the role played by audit committees -- first of all, very few audit committees meet more than three or four times a year and they rely almost solely on what is reported to them by management, internal audit representatives, and independent certified public accountants, all of whom spend full time performing their jobs and responsibilities. To state that audit committees represent the primary vehicle with regard to the company's financial reporting is illogical and would expose such committees to an unfair burden in litigation resulting from any fraudulent activities which might take place far down in the company's organization structure.

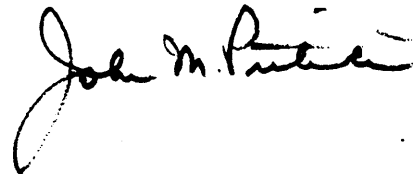
If these statements are not changed and put in proper perspective, those persons serving on audit committees will have the following options, either change the role of the committee by hiring its own full-time staff to fulfill the role as described above or refuse to serve on the audit committee. I don't believe that any knowledgeable individual would want to serve on an audit committee and bear the

National Commission on
Fraudulent Financial Reporting -2- June 23, 1987

responsibility as outlined by those two sentences without having a full time staff to actually perform those functions. Further, if staffs were hired by the committee, it would precipitate a chaotic situation and divide responsibilities at a tremendous expense to the company. If these statements are not corrected, I believe companies will have a very difficult time in getting qualified people to serve on audit committees because of the unwarranted additional liability they would be assuming.

I urge you to address this matter so that appropriate and reasonable responsibilities are placed on audit committees.

Sincerely,



JMP/sm



40

General Re Corporation
Financial Centre
P.O. Box 10351
Stamford, Connecticut 06904-2351
203 328-5557

Ronald G. Anderson
Vice President

June 23, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

This letter is in response to the Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting. As Chief Financial Officer of a major public corporation the topics covered in your report are of significant interest to me. Your Exposure Draft is a thoughtful, comprehensive, and at times, provocative document. I commend you for the effort required to produce a document which is likely to become a landmark.

We at General Re concur with the overall intent and thrust of the Report, and with a majority of the Commission's findings, conclusions and recommendations. However, we have concerns regarding the practical implications of two of the recommendations.

The Draft (Chapter 2, Section V, Page 41) recommends that "All public companies should be required by SEC rule to include in their Annual Report to Stockholders a letter signed by the Chairman of the Audit Committee describing the Committee's responsibilities and activities during the year". We believe that such a letter would serve little purpose. It would largely duplicate the recommended Management Report (with which we concur) discussed on Page 39 of the Exposure Draft and the Auditor's Opinion (which is already required by the SEC). Indeed the contents of such a letter could conceivably be misleading. For example, a relatively inactive audit committee could either mean that the committee itself is weak and inattentive, or it could mean that the company has strong management, adequate financial controls, an active internal audit group, and an effective independent auditor, so an active audit committee is not required.



40

National Commission on Fraudulent
Financial Reporting
June 23, 1987
Page Two

The Commission also recommends (Chapter 2, Section VI, Page 42) that "Audit Committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release". While conceptually appealing, I believe that the practical costs far outweigh the potential benefits. First, quarterly reporting schedules tend to be very tight, so that an additional layer of review will delay release of relevant information to shareholders. Second, Audit Committee members are very busy individuals - prior review of quarterly financials would require four additional audit committee meetings and may place a undue burden on many audit committee members. Third, the audit committee must rely on the company's management, internal auditors and the public audit firm for information. Those groups are free to access the audit committee at any point in time. If any individual has concerns about the accuracy or validity of financial information prior to release of quarterly earnings, the audit committee is currently empowered to act appropriately. Requiring a formal review will not increase the ability of audit committees to act.

I want to thank you for the opportunity to comment on the Commission's Exposure Draft.

Sincerely,

A handwritten signature in cursive script that reads "Ronald G. Anderson".

Ronald G. Anderson

RGA:mr

OFFICE OF THE DEAN
SCHOOL OF ACCOUNTING
(213) 743-2426



June 23, 1987

Mr. James C. Treadway, Jr., Chairman
Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Jim:

As a member of the Advisory Council to the Commission on Fraudulent Financial Reporting and as an educator, I'm pleased to respond to the exposure draft of the Commission.

On balance, I believe the Commission has set an attractive and challenging agenda for all parties involved in financial reporting. I support the posture taken by the Commission with the expectation of the recommendations on education. In this regard, I offer the following observations and suggestions with respect to Chapter 5.

1. I fully support the Commission's recommendations for additional liberal arts coverage as well as expansion of the business and accounting curriculum. However, it is inconsistent for the Commission to recognize the need for more educational preparation and to acknowledge that there has been an explosion of information related to accounting, systems, and related fields without specifically recommending that a minimum of five years of education be required. Further, the Commission emphasizes the importance of ethical inquiry, sound judgment, and analytical and problem solving skills, and observes that they take more time to develop than the simpler cognitive skills. I would add that the higher standards of a graduate-level program enable one to more fully develop these skills, and are more likely to produce graduates with the higher ethical standards and the professional commitment so essential to maintaining the public trust.

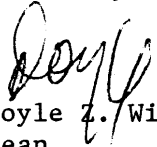
I strongly urge that the Commission explicitly state what is implicit in its observations throughout the chapter -- that the accounting curriculum can no longer be adequately covered in four years and should be increased to at least five years. I respectfully suggest that it do so by changing the word "may" to "must" in the second bullet under Section III on page 80, and by specifically stating in the Summary of Recommendations on page 12 that it recommends a minimum of five years of accounting education. Likewise, the discussion of four years versus five years on page 80 should be deleted.

Mr. James C. Treadway, Jr.
June 23, 1987
Page 2

2. I concur with the Commission that the development of faculty through actual work experience and the preparation of more relevant classroom materials are necessary to improve the learning process. However, unless the faculty reward system is modified to give greater recognition to these activities which improve teaching effectiveness and encourage interaction with the profession, there is little likelihood that the Commission's recommendation will be accomplished. I respectfully suggest that the Commission specifically address the need for greater flexibility in the academic reward system in order to achieve the stated benefits and to attract experienced people into the classroom.

Again, I commend the Commission for acknowledging the role of the educational process in helping to prevent and detect fraudulent financial reporting and agree with the goals that have been outlined. I feel that more specific guidance as to the implementation of several of its recommendations would make them more effective in directing changes in the curriculum.

Sincerely,


Doyle Z. Williams
Dean

DZW:vhb



SERVICE FRACTURING COMPANY

P. O. BOX 1741 • PHONE 806 665-7221 • PAMPA, TEXAS 79065

June 23, 1987

Honorable James C. Treadway, Jr.
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Ave. N.W.
Washington, D.C. 20006

Honorable Commission Treadway:

Our Company name is Service Fracturing Company, ticker symbol:
SERF, OTC: NASDAQ.

We do agree that proper oversight of publicly held companies financial reporting should be adequate to prevent and detect fraudulent financial reporting and respectfully submit the following comments concerning the Exposure Draft dated May 1, 1987 which we have received from the National Commission on Fraudulent Financial Reporting.

Review of the Exposure Draft reveals that many of the recommendations we not only agree with but have already voluntarily implemented as corporate policy, several of the recommendations can be satisfied by merely stating publicly what is being done.

The recommendations that relate to maintaining an internal audit function, adequately staffed, would cause great hardship on a company the size of Service Fracturing. To obtain competent consultants to perform the internal audit function on a part time basis would also incur proportionally higher cost for a company our size. The added burden on Audit Committees makes that cost rise as well as causing director liability insurance cost to increase when it is already very difficult to obtain and pay for. The ability to obtain competent outside directors becomes even more difficult.

The cost of implementing these recommendations will be onerous for a small company already struggling to compete. The proportional cost to a small company will create a very heavy burden. Is it possible to lower the requirements for the internal audit function and audit committee oversight responsibility for companies with lower volume sales or smaller balance sheet values?

Respectfully yours,

SERVICE FRACTURING COMPANY

Jerry A. Gunn
Jerry A. Gunn
President

JHG/es



43

GTE Corporation

Stephen E. Frank
Vice President-Controller

One Stamford Forum
Stamford, CT 06904
203 965-2000

June 23, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

GTE Corporation appreciates the opportunity to comment on the findings, conclusions and recommendations of the National Commission on Fraudulent Financial Reporting.

GTE fully supports the efforts of the Commission and we are in agreement with the thrust of the Commission's report. GTE shares the Commission's view that the integrity of financial reporting is the most critical element of the full and fair disclosure system in the United States. We also believe that the vast majority of public companies recognize the importance of this process, and consequently have implemented policies and practices which substantially comply with the Commission's recommendations.

We believe that the Commission's recommendations will contribute significantly to the ongoing efforts to reduce fraudulent financial reporting. However, as the Commission recognizes, since there are limits to the ability to prevent or detect fraud and since no study of the issue can ever be complete or final, we must carefully consider the costs and benefits associated with implementation of each of these recommendations and those of other organizations which will carry on this effort after the Commission is dissolved.

Specifically, there are several recommendations addressed to the public company for which we believe the benefits are minimal and would be outweighed by the inherent impracticalities. In addition, while we generally support the recommendations to strengthen the SEC's enforcement authority, we believe that certain of the recommendations may shift too much authority to the SEC, thus creating a potential for abuses.

June 23, 1987
National Commission on Fraudulent Financial Reporting
Page 2

Our comments regarding these specific recommendations are set forth below:

Recommendation 6: Public companies should ensure that their internal audit functions are objective.

While we agree with the intent of this recommendation, we believe that the supporting discussion should be modified in two areas. First, we disagree with the emphasis which the Commission has placed on an organizational structure in which the internal audit function reports directly to the CEO.

We believe (as the Commission acknowledges) that such a reporting relationship is neither practical nor the most effective in a larger corporation. Rather, in our opinion, it is more practical for the internal audit function to report directly to the individual within the organization who has the primary responsibility for the financial statements and can take the authoritative action to correct them. We recognize, however, that with such an organizational structure it is imperative that the chief internal auditor have the authority to bypass this reporting relationship and to report directly to higher levels of management and the audit committee if circumstances warrant.

Accordingly, we recommend that the Commission de-emphasize the importance of a relationship with the CEO, and rather, place greater emphasis on a reporting relationship which is appropriate and practical for the particular company.

Secondly, regarding the discussion of the chief internal auditor's background and experience, in our view, the criteria identified by the Commission are too narrow. We believe that there are instances in which individuals possessing qualifications other than prior audit training could equally fulfill the responsibilities of this position.

Recommendation 14: The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

While we agree with the spirit of this recommendation, we believe that with respect to large multinational corporations prior approval of the types and extent of management advisory services is impractical. Rather, we believe it would be desirable for audit committees to establish broad guidelines identifying the types of services for which it would be acceptable to engage the independent public accountants. These guidelines together with periodic review and annual approval by the audit committee of the extent of these services should be adequate to enable committee members to assess this factor in their evaluation of the independence of the company's public accountants.

June 23, 1987
National Commission on Fraudulent Financial Reporting
Page 3

Recommendation 16: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

We agree with the Commission's view that the oversight function of an audit committee is critical to the integrity of the financial reporting process. However, we can envision little benefit in requiring an additional report to be included in annual reports to shareholders, particularly at a time when companies are searching for ways to simplify financial reports in a effort to make these reports more understandable and useful.

The Commission indicates that such a letter would more effectively communicate to the investing public the role of the audit committee, and would reinforce audit committee members' awareness and acceptance of the importance of their responsibilities.

We believe that in view of the audit committee's critical role in ensuring the integrity of financial statements, a brief discussion of their role and activities should be included in the existing management report. In our opinion, this discussion together with the existing proxy statement disclosures would be more than adequate to effectively communicate the role of the audit committee.

Regarding the committee's awareness, we believe that for the most part members of audit committees are highly qualified professionals who are cognizant of the responsibilities they undertake on behalf of the board of directors. In our opinion, the inclusion of a letter in annual reports will not serve in any meaningful way to heighten their awareness.

Recommendation 18: When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

We fully support the Commission's initiative in dealing with the opinion shopping issue. However, we believe that this recommendation is overly burdensome and implies that the underlying motivation for changing auditors is merely to improve financial results. We believe that the Commission should recognize that there are valid reasons for changing auditors just as there are legitimate reasons for discussing accounting and auditing matters with other accountants.

Given the ever increasing complexities of business transactions and accounting standards, companies are finding it more and more difficult to determine the proper accounting and reporting for their business transactions. No accounting rules exist in some instances and the answers to many other problems are unclear.

While we fully recognize that abuses of the consultation process have and do occur, we do not believe that the problem is rampant nor that it is jeopardizing the quality of financial reporting to any significant degree. Accordingly, we believe that the existing Form 8-K requirements to disclose changes in and disagreements with auditors, supplemented by the Commission's recommendation that the audit committee review all consultations with other auditors on significant accounting issues should represent adequate deterrence against opinion shopping.

Recommendation 19: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We believe that the degree of participation in the quarterly reporting process should be assessed by the audit committee, rather than mandated by a Commission recommendation.

Audit committee members, through their participation on the full board, generally receive reports of financial results on a regular basis. In addition, to the extent that the audit committee is informed on a timely basis of any changes in accounting or financial reporting practices that may have a significant financial statement impact, and their ongoing evaluation of internal controls reveals no material weaknesses in the system, the benefit derived from pre-clearance of quarterly financial results would be minimal at best -- especially where public accountants are performing similar reviews.

Recommendation 31: The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.

Since it is reasonable to assume that two individuals can differ as to the soundness or propriety of a financial reporting practice, we believe that this recommendation may shift too much authority to the SEC. We believe that the SEC should be granted the authority to issue a cease and desist order only after a practice has been found to be fraudulent through full legal proceedings.

June 23, 1987
National Commission on Fraudulent Financial Reporting
Page 5

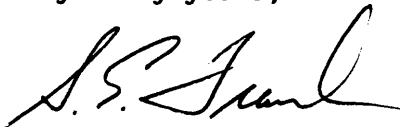
Recommendation 32: The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company.

Similar to the preceding recommendation, we believe that the SEC should be granted this authority only after the officer or director has been criminally convicted of participation in a fraudulent activity.

* * * * *

In summary, we would again like to express our support to the Commission in the accomplishment of its stated objectives and compliment it on the clarity and manner in which the report is presented. We appreciate the opportunity to express our views on this critical matter and we would be pleased to discuss further with the Commission the matters contained in this response.

Very truly yours,



S. E. Frank

R. H. Macy & Co., Inc.

G. G. MICHELSON
SENIOR VICE PRESIDENT
EXTERNAL AFFAIRS

HERALD SQUARE, NEW YORK, N. Y. 10001

June 23, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006

Dear Sirs:

At the outset, I would like to compliment you on your preliminary report on the subject of fraudulent financial reporting. Overall I think it is comprehensive and appropriate. As a member of the audit committee in a number of Corporations I take exception to the first two sentences contained in appendix "K" on Page 183 under the heading "Audit Committee Good Practice Guidelines".

I think it is an unrealistic overstatement of the role played by the audit committee to describe it as the "primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting". As presently constituted, audit committees must rely on management reports, internal audit representations, and independent certified public accountants whose full-time responsibilities involve reporting of financial matters. To hold audit committees primarily responsible when they meet perhaps quarterly and rely on others is not realistic. Such a standard will discourage membership on audit committees by responsible and conscientious directors who will recognize the inherent limitations of assuming such primary responsibility and will resist the added exposure for liability.

I strongly urge the rethinking and restatement of this standard.

Sincerely,

G. G. Michelson
(Mrs.) G. G. Michelson

GGM:mg

Route 1, Box 110
Hanover, VA 23069

June 23, 1987

The National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Dear Sirs:

As a stockholder and as an employee of a regulatory agency,
I applaud the concepts embodied in your exposure draft.
The cost/benefits issue must be considered but cost should
be given the back seat to provide increased public
confidence in the quality/accuracy of financial reporting.
I hope you will resist any efforts to weaken your proposals.

Very truly yours,


John M. Crockett

JMC/dc

AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC.

1270 AVENUE OF THE AMERICAS • NEW YORK 10020 • TELEPHONE: 212-765-2620

June 23, 1987

Mr. G. Dewey Arnold
Executive Director
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Mr. Arnold:

The Securities Law Committee of the American Society of Corporate Secretaries (the "Society") is pleased to have the opportunity to comment upon the April 1987 Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting. In 1986 a subcommittee chaired by Robert L. Robinson commenced study of the then developing legislative initiatives seeking to address financial fraud detection. That subcommittee, now chaired by Geoffrey C. Shepard, has reviewed the Exposure Draft of the Commission and prepared the enclosed summary of comments.

The Society is a professional association whose membership is composed principally of corporate secretaries, assistant secretaries and other persons involved in the duties normally associated with the corporate secretarial function. The Society's 3,000 members, representing approximately 2,300 corporations in the United States and Canada, are regularly involved in such matters as corporate governance, the regulation and trading of securities, proxy solicitation and other shareholder activities, and the administration of the office of the corporate secretary.

We believe the need for the Commission's work remains clear, that its analysis of the fraudulent financial reporting problem has been thorough, and that positive benefits will result from its work. We also believe the opportunity for comment on the Exposure Draft by interested parties will strengthen the product and make it more effective.

While we agree with the Commission's view that its recommendations should be taken as a whole, we do have comments on individual recommendations which we believe would be helpful to the Commission. We have confined these comments to recommendations contained in Chapter Two: Recommendations for the Public Company and to two recommendations made in Chapter Four: Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment. These are attached in a format which sets forth the Commission's recommendation in full followed by our comment. Where we believe the recommendation might be strengthened by specific wording changes, the suggested deletion has been bracketed and substitute wording has been underlined.

Finally, and perhaps most importantly, there are three overall themes running through our specific comments which we believe deserve special emphasis:

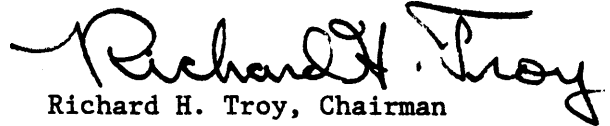
- * First, we remain strongly supportive of the twin concepts of self-regulation and the primacy of state jurisdiction over corporate governance issues. We do not believe the case has been made for increased regulatory involvement by the Securities and Exchange Commission (SEC) to the degree contained in the Exposure Draft.

We also continue to oppose creation of a federal corporation law, either directly by new legislation or indirectly by increased federal regulation, or in creation of a federal standard for corporate governance. The Commission's approach seems to finesse these issues, which we believe are too important not to be addressed forthrightly and directly.

- * Second, we believe a number of the Commission's recommendations, while salutary as goals, may not be cost effective -- particularly for smaller companies. To a considerable extent, this is why there appropriately are different listing requirements among the exchanges. We believe it would be prudent for the Commission to consider a more thorough cost benefit analysis of some of its recommendations to test whether a strong enough case can be made to justify the impact those recommendations may have on our mid- and small-sized companies. Perhaps in these instances, the Commission's recommendations ought to be in the nature of goals rather than mandates.
- * Finally, we believe a few of the Commission's recommendations may elevate form over substance. Upon reflection, the Commission may decide that their inclusion only undercuts its more important recommendations and provides unintended opportunities for the commission's critics.

We again wish to emphasize that we appreciate the opportunity to comment upon the exposure draft and would be pleased to meet with members of the Commission or its staff to further explore our response.

Respectfully submitted,



Richard H. Troy, Chairman
Securities Law Committee

CHAPTER TWO

RECOMMENDATIONS FOR THE PUBLIC COMPANY

TONE AT THE TOP

For the top management of a public company to discharge its obligation to oversee the financial reporting process, it [must] should take steps designed to identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

Comment: This recommendation might better be stated as a goal rather than a mandate to avoid the implication that top management must undertake a documentation effort similar to that required by the Foreign Corrupt Practices Act in order to avoid liability.

Public companies should maintain internal controls that are [adequate] designed to prevent and detect fraudulent financial reporting.

Comment: This recommendation also might better be stated as a goal rather than a mandate. Adequacy ought not be susceptible to being construed to mean "guaranteed to prevent fraudulent reporting". In addition, the concept of adequacy ought to be subject to cost-benefit considerations.

Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. A company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.

Comment: It is important to recognize that existence of a code of conduct does not in itself prevent improper conduct. However, some may consider a code of conduct is important to the establishment of the desired climate within the company. As such, we believe the Commission's recommendation could better be modified to encourage but not require that the company adopt such a code and to permit companies flexibility in determining the appropriate committee to monitor compliance.

If creation of the desired climate is the Commission's goal, the Commission's comment perhaps ought to stress that the purpose of a code of conduct is to discourage substantive misconduct and to encourage compliance. The comment also should make clear that such codes of conduct should be specific as to prohibited practices (which go far beyond fraudulent reporting) and not merely recite general principles; and that such codes should not be considered evidence.

We also believe it important for the Commission's comment to make the point that in cases involving fraudulent financial reporting, the absence of a code of conduct should not be considered evidence as to liability.

TWO KEY FUNCTIONS: ACCOUNTING AND INTERNAL AUDIT

Public companies should maintain accounting functions that are designed to [can effectively] meet their financial reporting obligations.

Comment: The recommendation as proposed by the Commission might well be read to imply that "effectively" means "guaranteed to prevent fraudulent reporting". We believe that the indicated modifications are appropriate to clarify the intent.

Public companies should maintain an [effective] internal audit function [staffed with an adequate number of qualified personnel] appropriate to the size and the nature of the company.

Comment: The suggested changes are designed to avoid the implication that an "effective" internal audit function guarantees the prevention of fraudulent reporting and also the implication that the number of internal auditors is determinative of the appropriateness of the internal audit function.

Public companies should [ensure] take steps designed to maintain the objectivity of their internal audit functions [are objective].

Comment: The suggested modifications are intended to afford companies appropriate latitude in the achievement of this goal.

Internal auditors should consider the implications of their non-financial audit findings for the company's financial statements.

Comment: We support the recommendation without additional comment.

Management and the audit committee should take steps to provide for [ensure that] the internal auditors' involvement in the audit of the entire financial reporting process [is appropriate] and for [properly] coordinat[ed]ion with the independent public accountant.

Comment: We believe that the modifications indicated are appropriate to avoid creating the implication that "appropriate" and "properly" mean "guaranteed to prevent fraudulent reporting". In addition, we are concerned that this recommendation without clarification may well lead to a duplication of effort within the company and raise cost-benefit concerns.

AUDIT COMMITTEE OF THE BOARD OF DIRECTORS

The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.

Comment: We suggest this recommendation be eliminated. The need for, practicality, appropriateness, and the effectiveness of an SEC rule as proposed is questionable. Although compliance with the recommendation is already a fact for NYSE-listed companies, many smaller companies do not have outside directors in sufficient numbers to comply with the recommendation. While the explanation of the Commission's recommendation suggests the SEC should be able to grant exceptions on a case-by-case basis, we do not believe this is an effective approach and might well be counter-productive.

If not eliminated, the recommendation might best be modified substantially to read as follows:

The board of directors of [all] public companies should [be required by SEC rule to] establish audit committees of which [comprised solely of] a majority of members would be independent directors.

If these modifications are incorporated, implementation of the modified recommendation would vary with the size of the company. Large companies traded on the New York Stock Exchange would have audit committees comprised solely of independent directors. The NASD does not yet have any rule on this point but has proposals before the SEC to require a minimum number of independent directors on audit committees.

Audit committees should [be informed, vigilant, and effective] oversee[rs of] the financial reporting process and the company's internal controls.

Comment: We believe any standard expressed in this draft recommendation could well become the standard applied in litigation. Such application would be inappropriate but nevertheless result in adverse decisions because the recommendation implies that fraudulent financial reporting could occur only if the members of the audit committee were not "informed, vigilant, and effective." While the audit committee can take reasonable steps to ensure that appropriate reviews and controls are in place, the existence of the audit committee cannot guarantee the elimination of fraudulent reporting -- as evidenced by the fact that 69% of the companies involved in SEC enforcement actions for fraudulent financial reporting had audit committees. We believe the Commission's emphasis might better be placed on encouraging the audit committee to take the steps as outlined in the Audit Committee Good Practice Guidelines.

All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter[, review it at least annually,] and modify it as necessary.

Comment: We support the concept of such a charter but question whether it is necessary to dictate the manner of implementation. Some companies annually adopt resolutions setting forth the responsibilities of each board committee. Other companies define committee responsibilities in by-laws. Further, there is no need to specify annual review if the recommendation makes clear that the charter should be modified as necessary.

Audit committees should have adequate resources and authority to discharge their responsibilities.

Comment: We support the recommendation. We believe the Commission's comment should emphasize that, while a separate staff for the audit committee should not be necessary, the audit committee should have standing authority to retain special counsel or experts. If the need arises for the audit committee to investigate suspicious occurrences, this standing authority should facilitate the investigation.

The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.

Comment: We support the recommendation without additional comment.

The audit committee should approve in advance the types and extent of management advisory services that management plans to engage the company's independent public accountant to perform.

Comment: We believe the Commission's explanation ought to be modified to make clear that the recommendation permits the advance approval of criteria for use of management advisory or other categories of services without requiring advance approval for a specific consultation. This change is particularly important to multinational companies which utilize accounting firms for tax advice in foreign locations and would be unable to function effectively if approval of the audit committee was required before making routine tax inquiries of accounting firms.

REPORTING TO THE PUBLIC ON MANAGEMENT AND AUDIT COMMITTEE RESPONSIBILITIES

All public companies should be encouraged [required by SEC rule] to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

Comment: This recommendation might better be modified as indicated to encourage companies to draft and include such statements if they determine that they are relevant.

In 1979, the SEC proposed amendments to Form 10-K, Regulation 14A and Regulation S-K requiring inclusion of a statement of management on internal accounting control in annual reports filed with the Commission on Form 10-K and in annual reports to the shareholders. The Commission also proposed that this statement be examined and reported on by an independent public accountant. We believe the criticisms that caused the SEC to withdraw its proposal in 1980 remain valid. Some generally

apply to the Commission's current draft recommendation for obligatory reports. In 1979, the American Society of Corporate Secretaries commented that companies should consider including in their financial reports a voluntary statement setting forth management's responsibility for the preparation and representation of financial statements and in the area of internal control. Even though the SEC proposal was withdrawn, companies have begun to experiment with such statements, seeking forms and language appropriate to their individual circumstances. We believe that such experimentation should be encouraged to continue.

All public companies should be required by the SEC to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

Comment: We believe this requirement might best be eliminated as it would not substantially further the goals of the Commission. The function of the audit committee -- oversight -- is already required to be described in the proxy statement of registered companies.

TWO ADDITIONAL RECOMMENDATIONS

Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.

Comment: We suggest reconsideration of this recommendation. A decision to seek a second opinion is one of many types of information which would normally be provided by management to the audit committee. Elevation of this particular item of information appears to give it undue emphasis. In addition, the recommendation as drafted raises a definitional issue: What would be considered to be a "significant issue".

When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

Comment: We believe this recommendation is unnecessary and may actually be harmful. During the course on an audit, companies and their auditors discuss material accounting and auditing issues, including taxation questions, in the normal course of business. The proposed disclosure requirement could well inhibit this necessary and free exchange.

Further, this recommendation could discourage companies from changing auditors for legitimate reasons other than disagreement on an accounting or auditing issue. The existing SEC disclosure requirements which cover "...any disagreement with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his report to the subject matter of the disagreement..." appear to be quite adequate.

Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

Comment: We do not believe that, as a general rule, the audit committee should be required to review or approve quarterly financial results prior to their release. We take this position for several reasons. First, pre-publication clearance is unnecessary if controls are adequate and the process for preparing quarterly reports is understood by the audit committee. Second, to require pre-publication clearance would greatly increase the burden upon audit committees and corporations (exposing the committee to litigation) and would unnecessarily delay release of quarterly results without increasing the protection afforded to shareholders. In addition, compliance with this recommendation would prove difficult for companies trying to comply with the NYSE rules regarding the reporting of earnings. Third, this recommendation blurs the distinction between what is clearly the audit committee's oversight responsibility and management's responsibility for financial reporting.

SETTING STANDARDS FOR INTERNAL CONTROL

The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

Comment: The goal of the recommended body is unclear. If the goal would be to provide small companies with assistance in interpreting and suggestions for implementing the various recommendations, it might be helpful. If the goal is to create a new accounting authority to pass on work done by other such authorities, its existence would be of questionable value.

In addition to comments on Chapter Two, we are pleased to bring to your attention our comments on two other recommendations.

CHAPTER FOUR

RECOMMENDATIONS FOR THE SEC AND OTHERS TO IMPROVE THE REGULATORY AND LEGAL ENVIRONMENT

The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company.

Comment: We have difficulty with the effectiveness of such a recommendation. It raises many questions of state corporate law (e.g. would such authority preempt current state authority to pass on the boards of companies regulated or licensed in the various states) and might well be difficult to implement on a national basis.

The SEC should reconsider its long-standing position that the corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable.

Comment: We believe this recommendation is appropriate especially in light of the difficulties in attracting and retaining independent directors being experienced by companies of all sizes.

1732c

THE
PROCTER & GAMBLE
COMPANY

GEORGE M. GIBSON
VICE PRESIDENT AND COMPTROLLER

P. O. Box 599
CINCINNATI, OHIO 45201

June 24, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

The Procter & Gamble Company has carefully reviewed the Commission's April 1987 Exposure Draft Report. We note that some of the suggestions we made in January, when we responded to your invitation to comment on your "initial conclusions", are incorporated in the current text, and we commend the Commission for its willingness to consider the views of other interested parties. We hope our additional comments, and the reiteration of some of our earlier ones, will contribute to a further improvement in the Commission's final product.

While there are a number of recommended changes — largely on aspects of the regulatory and legal environment — where we do not have sufficient expertise to take a position, the Company can unequivocally endorse most of the Commission's recommendations. With one exception, our concerns center not on the recommendations per se, but on the additional exhortations that surface only in the discussion material.

The exception is the recommendation for a letter in the annual report signed by the Chairman of the Audit Committee describing the Committee's responsibilities and activities during the year. We strongly oppose such a letter. It would not only be inappropriate in the annual report, but duplicates both existing proxy requirements and the widespread practice of including descriptions of the Committee's role in statements of management responsibility.

The discussions of the recommendations for the public company in Chapter Two of the Report contain a number of organizational arrangements and functional responsibilities and duties that the Commission has prescribed, prefaced "must" or "should", the same admonition utilized consistently in the formal recommendations. It may be that the discussion material was intended to be only explanatory and advisory, but unless the tone is changed

47
see also
232

to reflect that the Commission only "suggests", "encourages", or "endorses" these arrangements and practices, they will certainly be quoted with the same authority as the recommendations. If, on the other hand, these prescriptions are intended to have equal authority, they should be identified as recommendations and listed in summaries -- such as Appendix A -- which may be all many readers will review. The two examples that concern us most seriously are:

1. The code (of corporate conduct) "must provide an accessible internal complaint and appeal mechanism." While we acknowledge that such a mechanism does facilitate internal disclosures, it seems to be absolute overkill to mandate that an otherwise effective code of conduct could be judged deficient because it does not incorporate such an arrangement.
2. "The chief internal auditor should report administratively to a senior officer who is not directly responsible for preparing the company's financial statements." We strongly disagree with this recommendation. The chief internal auditor should administratively report to the officer to whom responsibility for establishing and maintaining internal accounting controls has been delegated, whether or not that officer's responsibilities include financial reporting. The internal audit function is essential to insuring that adequate controls are in place and are effective.

Sincerely,



GMG:jp
2225G

48

The Goodyear Tire & Rubber Company

Akron, Ohio 44316 - 0001

Robert E. Mercer
CHAIRMAN OF THE BOARD

June 24, 1987

Mr James Treadway, Chairman
National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Dear Mr Treadway:

I am aware of the preliminary report of The National Commission on Fraudulent Financial Reporting. For the most part, it represents a good summary of the things that are already being done by the companies with whom you are associated.

There is one section, however, that should be corrected. The first two sentences contained in Appendix K on page 183 under the heading "Audit Committee Good Practice Guidelines" read as follows: "An audit committee consisting of independent directors is the primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting."

These two sentences overstate considerably the role played by audit committees. First of all, very few audit committees meet more than three or four times a year and they rely almost solely on what is reported to them by management, internal audit representatives, and independent certified public accountants, all of whom spend full time performing their jobs and responsibilities. To state that audit committees, which cost the company "peanuts", represent the primary vehicle with regard to the company's financial reporting is absolutely ridiculous and would expose such committees to an unfair burden in litigation resulting from any fraudulent activities which might take place in the bowels of the company.

If these statements are not changed and put in proper perspective, those persons serving on audit committees will have the following options. Either change the role of the committee by hiring its own full-time staff to fulfill the role as described above, or get off the audit committee.

48a

Mr James Treadway
June 23, 1987
Page Two

I don't believe that any knowledgeable individual would want to serve on an audit committee and bear the responsibility as outlined by those two sentences without have a full-time staff to actually perform those functions. Further, if staffs were hired by the committee, it would precipitate a chaotic situation and divide responsibilities at a tremendous expense to the company. If these statements are not corrected, I believe companies will have a very difficult time in getting qualified people to serve on audit committees because of the unwarranted additional liability they would be assuming.

I therefore request that this correction by made on behalf of audit committees everywhere.

Very truly yours,



REM/ps

**ANHEUSER-BUSCH COMPANIES**

June 25, 1987

Mr. G. Dewey Arnold
Executive Director
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Mr. Arnold:

We are pleased to offer our comments on certain aspects of the April, 1987 Exposure Draft titled "Report of the National Commission on Fraudulent Financial Reporting". In releasing the Exposure Draft for public comment, the National Commission on Fraudulent Financial Reporting ("Commission") indicated it hoped to generate reactions, suggestions and opinions from those concerned with or affected by fraudulent financial reporting. As a major publicly owned corporation, our company and the Audit Committee of our Board of Directors is extremely interested in the subject of external financial reporting. As such, we commend the Commission in its work to date and its primary goal of identifying the major factors contributing to fraudulent financial reporting practices and the extent to which they can be prevented and at least detected.

We believe for the most part the Exposure Draft represents a good summary of the steps public companies should consider implementing in order to minimize the possibility of fraudulent financial reporting. However, we also believe that certain comments/suggestions contained in the Exposure Draft are overstated and unrealistic such that their implementation could result in a substantial burden on the company and its Audit Committee without clear benefit to the company or its shareholders.

The specific statements to which we refer and which represent the focus of our comments are as follows:

- Characterization of the Audit Committee as being the primary vehicle used by Board of Directors to discharge their responsibility with respect to the company's financial reporting; and
- The chief internal auditor should report administratively to a senior officer who is not directly responsible for preparing the company's financial statements.

Audit Committee Responsibilities

Anheuser-Busch strongly supports the Audit Committee concept and we support the general guidelines outlined in the Exposure Draft (Appendix K, page 184) on the structure and function of the Audit Committee. However, we believe the statements in the Exposure Draft (on pages 35 and 183) that (a)

the Audit Committee is the "primary vehicle that the Board of Directors uses to discharge its responsibility with respect to the company's financial reporting" and (b) the Audit Committee "represents one of the most effective influences for minimizing fraudulent financial reporting" are unrealistic and misleading. We believe these statements considerably overstate the role played by the Audit Committee.

Audit Committees generally meet no more than three or four times a year. As such, Audit Committees necessarily must rely on the company's system of internal control and information supplied to them by senior management, internal audit representatives and independent certified public accountants ... all of whom spend full time performing their duties and responsibilities. These factors (internal control, management, internal auditors and external auditors) all overseen by the Audit Committee, constitute the primary vehicles used by the Board of Directors to discharge their responsibility with respect to the company's financial reporting. To state that the Audit Committee itself is the primary control vehicle with regard to the integrity of the company's financial reporting is incorrect and would expose such Committees to an unfair burden from litigation due to any fraudulent activities which might take place at lower levels within a company.

Finally, if the Audit Committee is truly designed to be the primary vehicle for monitoring financial reporting, persons serving on such Committees will be required to hire their own full-time staff to fulfill their role or resign from the Committee. No knowledgeable individual would want to serve on an Audit Committee and bear the responsibility of primary control without having full-time staff to perform the necessary control functions. Such a situation would precipitate a chaotic environment of divided responsibilities at a considerable cost to the company, as well as make it very difficult to attract qualified individuals to serve on Audit Committees.

The solution to this problem would be simply for the Commission to revise the wording on pages 35 and 183 of the Exposure Draft to more accurately and realistically describe the role of the Audit Committee and its relationship with the true primary vehicles used to control the company's financial reporting process.

Internal Audit Function Reporting Relationship

The Exposure Draft recommends that the chief internal auditor report directly to a senior official who is not directly responsible for preparing the company's financial statements ... preferably the Chief Executive Officer. However, the Exposure Draft acknowledges that such an organizational structure (i.e. direct day to day reporting to the Chief Executive Officer) may be impractical in larger corporations. We agree and suggest that the Exposure Draft place less emphasis on the organizational structure/reporting relationship of the chief internal auditor and devote more attention to the internal audit function. We believe a reporting relationship of the internal audit function to the chief accounting officer in many cases is well justified and effective due to the intimate knowledge the chief accounting officer has of the company's operations and accounting/reporting functions. The chief

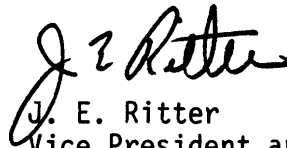
accounting officer is the management official in the best position to effectively direct the internal audit function to those areas most meaningful and important to the integrity of the financial reporting process.

Numerous other controls/procedures are available to ensure the integrity of the internal audit function other than organizational reporting relationships. These controls/procedures include direct and unrestricted access to the Chief Executive Officer and Audit Committee, as well as periodic and private meetings with such persons. To restrict and eliminate a sound and meaningful reporting relationship simply for appearance sake is short-sighted and in the long term would be detrimental to the internal audit function and financial reporting process.

* * * * *

We appreciate the opportunity to comment on these issues and would be pleased to elaborate on any of the foregoing should you desire us to do so.

Sincerely,



J. E. Ritter
Vice President and Group Executive
(Chief Financial Officer)

JER:cp

MAY 12 1987

50

The Riggs National Bank

of

Washington, D. C. 20074

(202) 835-5500

JOE L. ALLBRITTON
CHAIRMAN OF THE BOARD AND
CHIEF EXECUTIVE OFFICER

May 5, 1987

Mr. Thomas I. Storrs
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Tom:

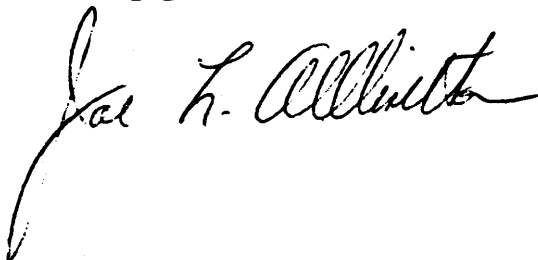
Thank you for sending a draft of the Report of the National Commission on Fraudulent Financial Reporting. You are absolutely right in saying that although the material sounds technical it is a subject crucial to all in business today. One only has to mention to fellow bankers such names as Penn Square, E.S.M., and Drysdale to emphasize the point.

Your observations and recommendations on the importance of the independent audit committee and internal audit departments are right on target. As chairman of the Riggs, a publicly owned national bank, I can easily vouch for the added value of these functions. But, in addition, with my experience with privately held companies, I wish to point out that so many of your recommendations easily make the transition to the private company. Accurate financial statements and sound internal controls are valuable to any prudent investor — public or private.

I commend your and the Commission's efforts and look forward to seeing the final paper.

Best regards.

Sincerely yours,



JUN 4 1987

51

McDERMOTT, WILL & EMERY
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

ONE POST OFFICE SQUARE
BOSTON, MASSACHUSETTS 02109
617/357-0200

2049 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067
213/277-4110

700 BRICKELL AVENUE
MIAMI, FLORIDA 33131
305/358-3500

111 WEST MONROE STREET
CHICAGO, ILLINOIS 60603-4067

312/372-2000

FACSIMILE 312/984-7700
TELEX 25-3565, 210079
CABLE MILAM

FIRST NATIONAL BANK BUILDING
SPRINGFIELD, ILLINOIS 62701
217/522-7200

101 NORTH MONROE STREET
TALLAHASSEE, FLORIDA 32301
904/222-2312

1850 K STREET, N. W.
WASHINGTON, D. C. 20006
202/887-8000

May 26, 1987

JOSEPH KEIG, JR., P.C.
312/984-7730

Mr. Thomas I. Storrs
One NCNB Plaza
Charlotte, North Carolina 28255

Re: National Commission on
Fraudulent Financial Reporting,
Draft Report of

Dear Tom:

I have read the subject draft report, and in my opinion it is excellent. Congratulations to you and the other members of the Commission.

I was particularly impressed with the emphasis on the vital role to be played by top management, including the board of directors. In the same vein, I think the Commission exercised good judgment in emphasizing the importance of able, active and independent audit committees and internal audit groups.

Thank you for the opportunity to review the draft report.

Sincerely,


Joseph Keig, Jr.

JK:hh

JUN 16 1987



George W. Ansbro
 Chairman, President and
 Chief Executive Officer

9300 Arrowpoint Boulevard
 Charlotte, N. C. 28210

June 12, 1987

Mr. Thomas I. Storrs
 #1 NCNB Plaza
 Charlotte, NC 28255

Dear Tom:

Thank you for your letter and the Report of the National Commission on Fraudulent Financial Reporting Exposure Draft. Since we are not under the requirement of reporting to the SEC, we thought it might be more appropriate if we address our comments to you rather than directly to the commission.

We are basically in agreement with the Commission's findings and believe they have handled a difficult subject very well through their multi-faceted approach. While all of the elements identified are important, we believe the tone set by top management and its conveyance to the staff is probably the most critical ingredient. Of the various roles identified for fraud avoidance/detection, we believe the Internal Audit function is equipped with the best "eyes and ears" and should be the primary focus, fully supported by the other recommended elements identified.

There are two recommendations in the draft that we take issue with as a matter of practicality. The first is Audit Committee approval before release of quarterly financial statements. We believe this would unreasonably delay the release of the financial statements and to some extent crosses the line from board responsibilities for the Audit Committee to operating responsibilities. The second area of disagreement is the recommendation that the Audit Committee approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform. We understand the Commission's position and we are generally sympathetic with it, and for this reason have made only very limited use of our auditors consulting services. However, we believe

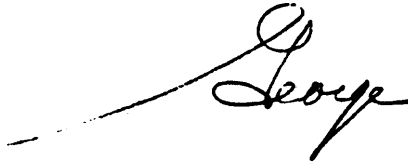
- 2 -

this should be covered after the fact by the Audit Committee when they hold their annual review of the audit program and fees. They can review auditor consulting utilization and then exert influence if they believe an unreasonable use or buildup is starting to occur.

Tom, we are pleased to note that we have most of the recommended "building blocks" in place, such as, an informed, vigilant and effective Audit Committee; a strong internal audit function; a strong independent public accountant relationship which includes coordination with internal audit; good internal controls and, we believe top management is setting the proper tone. Our review of the exposure draft has proven to be quite useful as it has provided us with some ideas on areas that we might modify to further strengthen the conduct of our operation to minimize our exposure.

Again, thanks for bringing this to our attention and if you like we will be pleased to discuss it with you further.

Sincerely,

A handwritten signature in cursive script, appearing to read "George". The signature is written in black ink and is positioned below the word "Sincerely,".

STEVEN H. RICE

589 FIFTH AVENUE
NEW YORK, NEW YORK 10017

.. (212) 759-6646

June 16, 1987

Mr. Thomas I. Storrs
One NCNB Plaza
Charlotte, North Carolina 28255

Dear Tom,

Thank you for passing along to me the draft report of the National Commission on Fraudulent Financial Reporting for comment.

The need for study and action in this area is indeed critical and I applaud the work and recommendations of your commission.

I do have some comments concerning the draft report.

The commission's definition of public company, as set forth on page 2 of the draft, includes mutual thrift institutions but excludes mutual insurance companies on the theory that abuses do not exist in that industry. Furthermore, private companies are excluded altogether notwithstanding the fact that abuses have surfaced in a number of these companies.

It would seem difficult to justify excluding any company these days from a discussion of fraudulent financial reporting be it private or public, mutual or stock, or federally regulated or state regulated. The impact fraudulent financial reporting can have on the investors, customers, regulators, employees, suppliers and others associated with any company argues for as broad a definition as possible of those institutions intended to be within the purview of this Report.

While suggesting that the Report could have been broader in it's scope, it also could have provided more detail as to (1) the abuses prevalent in the mutual thrift industry and (2) recommended corrective and preventive action in this specific area.

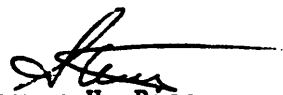
53a

Steven H. Rice
June 16, 1987
Page Two

With respect to financial institution regulatory agencies and the Commission's recommendation on page 69, that the various bank regulatory agencies "should adopt measures patterned on the Commission's recommendations directed to the SEC to carry out their own regulatory responsibility relating to financial reporting under federal security laws", it also would seem appropriate to include the various state regulatory agencies here, particularly since mutual thrifts are, in many instances, state chartered institutions.

Tom, I do very much appreciate the opportunity to review the fine work of the Commission and look forward to the implementation of its' recommendations in the years ahead.

Sincerely,


Steven H. Rice

SHR/ndj

JUN 24 1987

54

MULTIMEDIA, INC.

803-298-4364
P. O. BOX 1688
GREENVILLE, SOUTH CAROLINA
29602

WILSON C. WEARN
Chairman

June 22, 1987

Mr. Thomas I. Storrs
Retired Chairman of the Board
NCNB Corporation
One NCNB Plaza
Charlotte, NC 28255

Dear Tom:

Finally, I have completed my review of your "Report of the National Commission on Fraudulent Financial Reporting." In general, I subscribe to your recommendations and commend you for your willingness to take a leadership position in this worthwhile endeavor.

One of your Commission's recommendations, however, might well be worth further consideration. I refer specifically to the recommendation that the Board of Directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors. While on the face of it this recommendation may seem logical, I do not believe it is possible that it can be implemented in the near future.

For several years I have been a member of the Board of Governors of the National Association of Securities Dealers. As you undoubtedly know, NASD is an SRO for the over-the-counter market and it also operates NASDAQ. About two years ago, in response to a recommendation of the Corporate Advisory Board (of which I am Chairman), NASD adopted a number of rules regarding corporate governance that have established requirements for NMS companies trading on NASDAQ. NASD rules now require that all NMS companies have independent directors and that the majority membership of all audit committees must be comprised of independent directors. Frankly, I think the "majority" requirement is entirely adequate. Furthermore, to attempt to impose even this standard on the hundreds and hundreds of small



MULTIMEDIA

54a

Mr. Thomas I. Storrs
June 22, 1987
Page Two

Tier II companies on NASDAQ would be looked upon in many quarters as radical. I wonder also if the recommendations in your report are to be applied to the thousands of "non-listed" companies.

Tom, I would like the opportunity of discussing this matter with you in the near future. Perhaps we can have an initial conversation at the Board meeting on Wednesday of this week.

With best regards.

Sincerely,



Wilson C. Wearn

WCW/js

John F. Burlingame
P. O. Box 8300
260 Long Ridge Road
Stamford, Connecticut 06904
(203) 373-2520

June 22, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Ave., N.W.
Washington, D.C. 20004

Gentlemen:

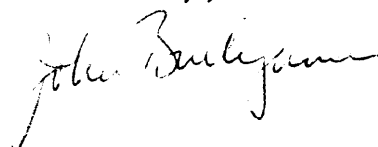
I have had the opportunity to read your preliminary report and would like to take issue with two points - first, that "an audit committee is the primary vehicle boards of directors use to discharge their responsibility with respect to the company's financial reporting" and second, that "an informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting."

My objections are on several levels. First, this is simply not the fact and never has been. The audit committees have not had this responsibility, have not had the financial or physical resources to discharge such a responsibility and should not have them. Second, the responsibility has been and should be with the public accountants which are both paid the fees and have the resources to this job. Third, the audit committee's function, and it is an important one, is (1) to assure that the public accountants are doing a reasonable job, (2) that they have a communications path to the Board of Directors separate from their management communications linkage and (3) that those deficiencies uncovered by the public accountants in organization, personnel, systems or procedures are adequately corrected by the management.

If the responsibilities stated by the report should become the norm, it would require a separate activity duplicating most of the functions now accomplished by the public accountants. This would increase the costs for no other reason than shifting a responsibility now properly placed to another activity not equipped to discharge it.

I would hope the Commission would give further thought to this issue. Rather than solving the accountants' liability problem, it will, in my view, seriously weaken their role in and relationship with corporate America.

Sincerely,



Charlotte
June 23, 1987

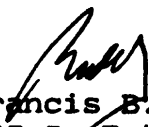
Mr. Storrs

Commission on Fraudulent Financial Reporting

You will undoubtedly receive more knowledgeable and thoughtful comments regarding this draft report, but I have outlined some reactions as you requested.

1. Rather than requiring pre-approval by the Audit Committee for engagement of the independent public accountant for management advisory services, it would seem preferable to allow after-the-fact reporting of any such engagement. Although in our own experience we rarely select Price Waterhouse for such projects, they often compete for the business. Until we have reviewed the relative qualifications, cost, etc. of the several firms being considered, we are not able to gauge the likelihood of needing Audit Committee approval. Such a requirement would either delay the process somewhat, or more likely, effectively preclude consideration of the firm doing the audit engagement.
2. The requirement for a letter from the Audit Committee chairman in the annual report to stockholders seemed excessive; including such a letter in some SEC filing or the proxy statement would seem sufficient.
3. The report in several places contends that cost effective responses have been of paramount consideration and that the costs are justified by the benefits. I am unable to assess the cost and burden of these proposals, but I am equally unable to accept the assertion that it is not a problem. There is probably no effective means of removing this uncertainty, and it will likely become a point of debate.

Overall, the report seemed very well done and would make significant contributions toward minimizing the problems being addressed.


Francis B. Kemp - President, NCNB Corporation
T23-5 Ext. 5678

Honeywell

WILLIAM H. MACKEY
Vice President and Controller

June 23, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Dear Sir:

We appreciate the opportunity to comment on the exposure draft on fraudulent financial reporting. On an overall basis, we believe that the findings, conclusions, and recommendations included in the exposure draft are appropriate. The National Commission is to be commended for its excellent work.

Following are our recommendations for change in Chapter Two, Recommendations for the Public Company:

- 1. **Recommendation:** Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.

The exposure draft indicates that the chief accounting officer is directly responsible for the financial statements, can take authoritative action to correct them, and should be held responsible for fraudulent financial reporting.

We believe that the exposure draft significantly overstates the chief accounting officer's responsibility for the financial statements. The chief executive officer and the chief financial officer have as much responsibility for the financial statements as the chief accounting officer. We view this as a "shared" responsibility. We believe that the language in the exposure draft should be modified to incorporate this concept.

- 2. **Recommendation:** Public companies should ensure that their internal audit functions are objective.

The exposure draft indicates that the chief internal auditor should not report administratively to a senior officer who is responsible for preparing the company's financial statements. The exposure draft recommends that the chief internal auditor report to the CEO, but acknowledges that this may be impractical in larger corporations. The exposure draft recommends that, at a minimum, the chief internal auditor have direct and unrestricted access to the CEO and meet with the CEO at least every quarter.

EXPOSURE DRAFT COMMENTS

Page -2-

For a multinational company that has decentralized operations and records, we believe that the chief internal auditor should report administratively to the corporate vice president and controller. We believe that this relationship on balance enhances the control environment and is the most practical in the circumstances.

We believe that it would be more appropriate for the Commission to emphasize the importance of internal audit having unrestricted access to records, the audit committee, and the CEO, rather than the reporting relationship.

Also, we recommend that the CEO and audit committee review periodically the objectivity and independence of the internal audit function, including possible changes in reporting relationships if there is, in fact, a possibility that the financial reporting process could be compromised by the reporting relationship.

Although we have no objections to the chief internal auditor meeting with the CEO, we strongly object to any recommendation specifying the frequency of such meetings. The important concept that should be emphasized is that the chief internal auditor should have unrestricted access to the CEO.

3. **Recommendation:** Management and the audit committee should insure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.

The exposure draft indicates that many internal audit groups concentrate their audit activities at the division level. The independent public accountant is often responsible for the audit at the corporate level. The exposure draft indicates that the internal auditors should be more involved at the corporate level.

We believe that the independent public accountants and internal auditors are in the best position to determine how the overall audit should be coordinated to achieve appropriate audit coverage without duplicating audit effort. Accordingly, we do not believe that it is appropriate for the Commission to single out particular areas where internal auditors or independent public accountants should concentrate their audit efforts.

4. **Recommendation:** All public companies should be required by SEC rule to include in their annual reports to stockholders a letter, signed by the chairman of the audit committee, describing the committee's responsibilities and activities during the year.

EXPOSURE DRAFT COMMENTS

Page -3-

We question whether inclusion of such a letter in the annual report will add value to the financial reporting process. We do not believe that inclusion of a separate letter will benefit the users of financial statements. As an alternative, we believe that management's report on responsibility for financial reporting is an appropriate vehicle for management to comment on internal controls, the financial reporting process, internal auditors and independent public accountants, and the role of the audit committee.

To add another separate report commenting on the financial reporting process from the chairman of the audit committee seems unnecessary, potentially redundant, and could be confusing to users of the financial statements. We also believe that the addition of another separate report would be inconsistent with the SEC's objective of simplifying annual reports.

- 5. Recommendation: The audit committee should approve, in advance, the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

We believe that all audit and non-audit services should be reviewed by audit committees. However, we believe that audit committees should make the determination when it is appropriate to review such services. As indicated in the exposure draft, there has never been a case where an independent public accountant performed management advisory services and compromised his independence. Accordingly, we believe that audit committees should have the option of reviewing non-audit services after-the-fact.

- 6. Recommendation: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We agree that audit committees should oversee the quarterly reporting process. However, we believe that audit committees should make the determination whether reviewing quarterly financial results prior to public release is necessary. When internal controls are strong, we do not believe that such a review is necessary. Requiring approval of financial results prior to public release is impractical, unnecessary, and will likely result in a delay in the release of information to the public for the vast majority of public companies.

EXPOSURE DRAFT COMMENTS

Page -4-

Following is a recommendation for change in Chapter Three,
Recommendation for the Independent Public Accountant:

Recommendation: The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.

We do not believe that a timely review of quarterly financial information by independent public accountants is necessary for all public companies. Our independent public accountants formally review the quarterly information at the time that they perform the annual audit. We believe that our current practice is appropriate for the following reasons:

- o We have strong internal controls.
- o We maintain a continuous dialogue with our independent public accountants on all important financial matters. We make sure that any important financial matters are discussed prior to releasing the quarterly financial information.
- o We have never had to make an adjustment to our quarterly financial information.
- o A timely review would require that the independent public accountants visit outlying locations more frequently. As a result, we would incur additional costs.
- o A timely review would delay our release of the information to the public.

Very truly yours,



W.H. Mackey/th

HERSHEY
ENTERTAINMENT & RESORT COMPANY
300 PARK BOULEVARD • P.O. BOX 860 • HERSHEY, PA 17033

Edward R. Book
Chairman and
Chief Executive Officer
717/534-3300

June 23, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Gentlemen:

Congratulations on your report which has been circulated to me by both Arthur Andersen and Ernst & Whinney. The report represents a good summary of the kind of work that is already being done by the companies with which I'm associated. I would like to call to your attention, however, the fact that the statements contained in the section headed **Audit Committee Good Practice Guidelines** that reads as follows: "An audit committee consisting of independent directors is the primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting."

In my opinion, these two sentences considerably overstate the role played by audit committees. An audit committee which meets three or four times a year and relies on what is reported to them by management, internal audit staff and independent certified public accountants, would be an unrealistic and impractical replacement for those who spend their full time performing various audit control functions as a part of their full-time job responsibilities. The audit committee is not the primary vehicle with regard to the company's financial reporting. This kind of statement, in my opinion, would expose audit committees to an unfair burden and would, in fact, have them terribly vulnerable for litigation that may arise from any fraudulent activities which could take place in the depths of a company or organization.

These statements need to be changed to reflect more properly the oversight and propriety and appropriateness of controls and activities of the management, internal audit and extra auditing functions of a corporation. If these statements are not corrected, companies will have a very difficult time in getting qualified people to serve on audit committees because of the unwarranted additional liability they would be assuming.

I do hope you will give these thoughts your consideration as you prepare your final report.

Sincerely yours,



ERB:nsh



THE INSTITUTE OF INTERNAL AUDITORS
CALGARY CHAPTER

ADDRESS REPLY TO:

David Townsend,
8818 MacLeod Trail, S.E.,
Calgary, Alberta,
T2H 0M5.

June 24, 1987

National Commission on
Fraudulent Financial Reporting,
1701 Pennsylvania Avenue, N.W.,
Washington, D.C. 20006,
U.S.A.

Dear Sir,

We recently held an Investigative Auditing seminar geared toward Internal Auditors. The interest in this topic was very high and all attendees were very positive about the information they gained.

The seminar was designed to obtain input from a number of different disciplines, i.e. legal, security, forensic accounting, criminal investigating. From the feedback that we received, we felt that this approach was very effective in meeting your "Recommendations for Education" in your Exposure Draft of April, 1987.

For your information, please find enclosed a copy of our course outline.

If we can be of any further assistance, please feel free to contact us.

Yours truly,

David Townsend

David Townsend
Education Governor

DT/jm
Enclosure

cc: T. Leech - Secretary - Calgary Chapter
Mano Rasiah - President - Calgary Chapter

SEMINAR AGENDA

INVESTIGATIVE AUDITING - AN INTERNAL PERSPECTIVE

PRESENTED BY:

R.J. LINDQUIST, C.A.
B.L. PACHKOWSKI, C.A.
T.J. LEECH, C.A., M.B.A.

COORDINATED BY:

THE INSTITUTE OF INTERNAL AUDITORS
CALGARY CHAPTER AND
PEAT MARWICK LINDQUIST HOLMES
AND
TIM J. LEECH

INVESTIGATIVE AUDITING
- AN INTERNAL PERSPECTIVE -

TABLE OF CONTENTS

<u>SUBJECT</u>	<u>PAGE</u>
INTRODUCTION	1
WILL INVESTIGATIVE AUDITING BE LEGISLATED?	2
ASSESSING YOUR ENVIRONMENT AND EXPOSURE	3
DISMISSAL FOR CAUSE	4
FIRST LINE OF DEFENCE - POLICY, PROCEDURE & TRAINING	5
FRAUD AND OTHER ILLEGAL ACTS DEFINED	6
INVESTIGATIVE AUDIT MENTALITY	7
INVESTIGATIVE AUDITING - TOOLS & TECHNIQUES TO DETECT POSSIBLE WRONG DOING	8
HOW TO PROTECT YOUR POSITION WHILE RESPONDING	9
ESTABLISHING IN-HOUSE INVESTIGATIVE AUDITING EXPERTISE	10
WORKING WITH YOUR SECURITY DEPARTMENT	11
THE JUDICIAL PROCESS	12
WORKING WITH LAW ENFORCEMENT	13

DAY 1

8:30 - 9:00

OPENING REMARKS

(DAVE TOWNSEND/BOB LINDQUIST)

9:00 - 10:30

WILL INVESTIGATIVE AUDITING BE LEGISLATED?

THIS SESSION WILL PROVIDE AN OVERVIEW OF DEVELOPMENTS IN THE U.S. AND CANADA THAT INDICATE THAT THE PUBLIC EXPECTS DIRECTORS, MANAGEMENT AND AUDITORS TO BE MORE PROACTIVE IN TAKING STEPS TO PREVENT AND DETECT FRAUD.

(TIM LEECH)

10:30 - 10:45

BREAK

10:45 - 12:15

ASSESSING YOUR ENVIRONMENT AND EXPOSURE

THIS SESSION WILL PROVIDE SOME INSIGHTS INTO TECHNIQUES THAT CAN BE UTILIZED TO ASSESS YOUR COMPANY'S EXPOSURE TO FRAUD AND OTHER ILLEGAL ACTS.

(BOB LINDQUIST)

12:15 - 1:30

LUNCHEON ADDRESS

DISMISSAL FOR CAUSE

(RICHARD B. LOW, BENNETT JONES)

1:30 - 4:30

FIRST LINE OF DEFENSE - POLICY, PROCEDURE AND TRAINING

(2:45 - 3:00

BREAK)

TOPICS WILL INCLUDE:

- o CORPORATE CODES OF CONDUCT
- o EMPLOYEE COMPLIANCE REPRESENTATIONS
- o RIGHT TO AUDIT CLAUSES
- o VENDOR LETTERS
- o SELF-ASSESSMENT AND REPRESENTATION PROCESS
- o IMPORTANCE OF CONTROL AWARENESS TRAINING
- o CONTINGENCY PLAN INCLUDING INSURANCE REQUIREMENTS
- o PROTECTION FOR WHISTLE BLOWERS
- o EXIT INTERVIEWS
- o CASE HISTORIES

(TIM LEECH/BRUCE PACHKOWSKI)

DAY 2

(CONTINUED)

3:00 - 4:30

HOW TO PROTECT YOUR POSITION WHILE RESPONDING

TOPICS WILL INCLUDE:

- O HARASSMENT
- O LIABLE AND SLANDER
- O WRONGFUL DISMISSAL SUITS - HOW TO AVOID THEM
- O THE AUDITOR AS A "PERSON IN AUTHORITY"
- O INTERVIEWING PRECAUTIONS
- O EVIDENCE ADMISSIBILITY/COLLECTION
- O POLYGRAPHS
- O PRESCREENING RIGHTS

(FRANK R. FORAN, HOWARD MACKIE)

DAY 3

7:45 - 9:00 BREAKFAST PRESENTATION (OPTIONAL)

9:30 - 10:30 ESTABLISHING IN-HOUSE INVESTIGATIVE AUDITING EXPERTISE

TOPICS WILL INCLUDE:

- O MOTIVE
- O NEED
- O TRAINING
- O POLITICS
- O QUESTION PERIOD

(TIM LEECH)

10:30 - 10:45 BREAK

10:45 - 12:00 WORKING WITH YOUR SECURITY DEPARTMENT

THIS SESSION WILL DISCUSS THE ROLE A SECURITY DEPARTMENT PLAYS IN THE INVESTIGATION OF FRAUD AND OTHER ILLEGAL ACTS INCLUDING LIAISON WITH LAW ENFORCEMENT, LEGAL COUNSEL, AND INTERNAL AUDIT.

(MR. KEN C. JOHNSON, SECURITY ADVISOR - WESTERN CANADA: IMPERIAL OIL LIMITED)

12:00 - 1:30 LUNCHEON ADDRESS - THE JUDICIAL PROCESS

TOPICS WILL INCLUDE:

- O CRIMINAL VERSUS CIVIL
- O THE LEGAL PROCESS - CRIMINAL
- O YOUR ROLE AS A WITNESS

(BRYAN D. NEWTON - SPECIAL PROSECUTIONS BRANCH, ALBERTA ATTORNEY GENERAL)

1:30 - 2:30 WORKING WITH LAW ENFORCEMENT

TOPICS WILL INCLUDE:

- O WHO TO CALL FOR WHAT
- O WHAT WILL THEY EXPECT OF YOU
- O WHAT SHOULD YOU EXPECT OF THEM

(CALGARY POLICE SERVICE - DETECTIVE BEV ISAACS)

2:30 - 3:00 ROUND TABLE DISCUSSION

- BOB LINDQUIST
- KEN JOHNSON
- BRYAN NEWTON
- BEV ISAACS
- TIM LEECH

3:00 CLOSE



Certified Public Accountants

June 24, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sirs:

We are pleased to respond to the "Report of the National Commission on Fraudulent Financial Reporting" Exposure Draft issued April, 1987. We believe the Exposure Draft is generally a very good and practical document. We have considered the recommendations as a whole and agree that they form a balanced response to fraudulent financial reporting. Our observations and comments focus mainly on the need for clarification of certain points although we do disagree with your approach to restructuring the Auditing Standards Board. Furthermore, since we are a CPA firm, our response primarily covers recommendations in Chapter 3 of the draft.

Chapter 2: Item VI - Changing Independent Public Accountants

The Commission recommends that a public company disclose the nature of any material accounting or auditing issues discussed with its old and new auditors during the three years preceding the change.

To make this an effective recommendation, we believe two issues must be addressed as part of the recommendation.

- Guidance should be provided as to the types of issues such a report should consider, and
- A specific procedure should be established as to how the independent public accountants are to respond to the issues raised or omitted by the company.

Chapter 3: Item III - Analytical Review Procedures

The Commission has recommended that auditing standards be revised to require the use of analytical review procedures on all audit engagements including the planning phase of audits. We recognize that the use of analytical review procedures are very helpful in the planning phase and overall review of an audit. However, in some circumstances, an effective audit can be performed without performing analytical review procedures in the planning stages and as an overall review of financial information. This is especially true in auditing a smaller business.

60a

National Commission on Fraudulent
Financial Reporting
June 24, 1987
Page 2

We suggest that the absolute requirement recommended in the Exposure Draft be replaced with wording that strongly urges the use of analytical review procedures, but does not require such procedures in each and every audit and in both the planning and overall review phases of each audit.

Chapter 3: Item III - Timely Review of Quarterly Financial Data

We realize that this is a somewhat technical comment, but the recommendation that the SEC should require independent public accountants to review quarterly financial data of public companies before release to the public should be moved from Chapter 3 to Chapter 4, "Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment."

The CPA does not have the ability to force this review of the quarterly financial data. Only through the directive of a regulatory authority will this recommendation be able to be implemented.

Chapter 3: Item VI - Reorganization of the Auditing Standards Board

The Committee recommended that the AICPA reduce the number of members on the Auditing Standards Board from 21 to 8 or 12 members, half of which would not be CPA's in public practice. In addition, the Committee recommended a strengthening of the senior staff.

We agree that an increase in the number of technically qualified senior staff to assist in drafting technical standards would be beneficial to the ASB and provide a more efficient avenue for the writing, review and passage of technical standards.

We strongly oppose, however, the proposed restructuring as presented. The current format provides the ASB a broad based representation of the body which it regulates, the AICPA. Limiting the percentage of practicing CPA's will detract significantly from the strong feeling of representative regulation that is a foundation of the profession. Limiting the number of members to 8 or 12 would restrict the Board's ability to receive a variety of views on a given subject. The AICPA only this year increased the size of the Board from 15 to 21 to increase participation by those most affected by its decision. We believe the Board would benefit from increased involvement from nonpublic accounting professionals. However, we recommend keeping the total members approximately at the current 21 member level with approximately one-third of the members not being CPA's in public practice.

National Commission on Fraudulent
Financial Reporting
June 24, 1987
Page 3

In closing, we commend the efforts of the Commission in providing a broad foundation for the various groups that are concerned with the effect of fraudulent financial reporting. By working from this foundation, the individual groups may now structure their own specific response to this fundamental problem.

Very truly yours,

Crowe, Chizek and Company

CROWE, CHIZEK AND COMPANY



**PUBLIC
SERVICE
INDIANA**

June 24, 1987

Hugh A. Barker
Chairman and
Chief Executive Officer

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D.C. 20006

Gentlemen:

Public Service Indiana is pleased to submit comments in response to your exposure draft, Report of the National Commission on Fraudulent Financial Reporting. Public Service Indiana is an investor owned electric utility serving 560,000 customers in central and southern Indiana. In 1986 our revenues exceeded \$1 billion and our utility plant was approximately \$1.6 billion.

We support this private-sector initiative to improve the integrity of the financial reporting process. We are constantly reminded of the growing problem of fraud through news media accounts. Public opinion polls reflect that the reputation of the entire business community is at risk.

With respect to your recommendations for public companies, we find the majority to be reasonable. Without question, the primary responsibility for financial statements and related disclosures belongs to management. We are in agreement the audit committee serves an important oversight role with respect to financial reporting. However, we believe certain recommendations pertaining to the audit committee should be reconsidered. Certain of your recommendations circumscribe management's discretion unnecessarily by requiring prior audit committee approval. For example, contrary to your recommendation we do not believe it appropriate for the audit committee to approve, in advance, the engagement of the company's independent public accountant to perform management advisory services. Evaluation of the public accounting firm's independence is an important duty of the audit committee. However, just as there is an absence of evidence to suggest that the independence of public accounting firms has been compromised as a result of providing non-audit services, there is no reason to believe the audit committee's oversight role is inadequate in evaluating the independence of the accountant/client relationship.

62a



National Commission on Fraudulent
Financial Reporting
June 24, 1987
Page 2

Likewise, we do not believe it necessary for the audit committee to approve, in advance, the release of interim financial statements. We believe the audit committee can fulfill its financial reporting oversight role without prior approval authority. There is no reason to believe management would provide more credible financial statements if the audit committee reviewed them prior to release rather than on an ongoing basis, even retrospectively. In addition, we find this requirement undesirable as it dictates a minimum frequency (4) and the timing of audit committee meetings. Considering scheduling implications, requiring reviews of interim data prior to publication without adversely affecting the timeliness of its release is difficult, at best.

The activities and responsibilities of audit committees have increased significantly in the last decade. Requiring more than can reasonably be accomplished within the time these individuals can commit to such activities indeed risks dilution of their primary, essential functions. Inserting the audit committee in the routine approval process contributes to this risk.

Unarguably, reviews of the public accountant's independence and of important financial data fall within the scope of the audit committee's oversight role. However, the needs and circumstances of each company will differ. For this reason, your recommendations should emphasize the audit committee's scope of responsibility, leaving discretion to delineate the means to accomplish specific responsibilities with management and audit committee members.

With respect to your recommendation requiring, by SEC rule, a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year be included in annual reports to stockholders, we believe current proxy statement disclosure is adequate. We foresee no real benefit to the investing public by adoption of this recommendation.

We appreciate this opportunity to provide our comments on this critical matter. Given the current mood of Congress, the business community must demonstrate its ability to self-regulate its financial reporting conduct or undesirable consequences seem inevitable.

Very truly yours,

Hugh A. Barker

W. R. PERSONS
BECK BLDG.
7811 CARONDELET AVENUE
CLAYTON, MISSOURI 63105

June 24, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Ave., N.W.
Washington, D. C.

Gentlemen:

My attention is called to the preliminary report of your Commission on Fraudulent Financial Reporting.

Appendix K on page 183 states, "An audit committee consisting of independent directors is the primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting."

Having served on audit committee of four major corporations, I strongly object to your exact language used in those first two sentences. While audit committees have stepped up the level of the depth of their inquiry into the details of procedure and personnel involved in the company's financial reporting, I must submit that the Audit Committee's principal function is to carefully cross-examine the Independent Certified Public Accountants, the Internal Audit executives, and top management itself; and I would suggest that your committee by its present wording, not shift responsibility away from those three key areas.

I applaud your efforts toward elimination of fraudulent financial reporting. However, I believe you would be best served by developing a full set of questions and examination procedures for Audit Committees, laying proper responsibility on top management and particularly, Independent Certified Public Accountants.

Sincerely,


W. R. Persons



National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006

June 24, 1987

Subject: Comments to Exposure Draft - Report of the National
Commission on Fraudulent Financial Reporting

Gentlemen:

We appreciate the opportunity to comment to the subject exposure draft. We are in general agreement with the conclusions set forth therein, including the Commission's comments that:

- ... The responsibility for reliable financial reporting resides first and foremost at the corporate level;
- ... Public confidence in the extensive financial reporting by public companies must be maintained to ensure effective functioning of the capital and credit markets in the United States; and
- ... A realistic potential exists for reducing the risk of fraudulent financial reporting, provided the problem is considered and addressed as multidimensional, i.e., there are roles for the company and its management, the independent public accountant, regulatory and law enforcement agencies, educators, etc.

However, we are concerned that some of the specific recommendations may be a deterrent to the public markets if they become rigid requirements. Extreme care must be exercised so that the costs and complexities of participating in these markets do not become so onerous to smaller companies as to effectively exclude them. The areas that offer the greatest potential for overkill would be legislatively-mandated expansion of oversight and enforcement tools for the SEC and other regulatory agencies and the significantly expanded role of the independent public accountant.

The following paragraphs present our comments on certain of the Commission's recommendations for public companies, independent public accountants and the SEC.

RECOMMENDATIONS FOR THE PUBLIC COMPANY



In this area, we are in general agreement with the recommendations; however, we are not convinced that all recommendations dealing with audit committees are appropriate.

Mandatory Independent Audit Committee - We generally agree that an effective committee comprised solely of independent directors is an important component in the board of directors carrying out its responsibilities for financial reporting. Accordingly, the establishment of audit committees should be encouraged but not mandated. The principal objective is for the board of directors to provide adequate oversight without specifying the exact form of the oversight. As the Commission notes, many smaller companies may have difficulty meeting this requirement due to their inability to attract outside directors; therefore, any SEC requirements in this area should provide for exception to recognize alternative procedures and controls that are functionally equivalent to an audit committee.

Reporting on Responsibilities in the Annual Report to Stockholders - We do not agree that the SEC should require companies to include a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities. Such a letter would only add boilerplate to the annual report that would serve little purpose, particularly if the committee's responsibilities are described in management's reports to the stockholders.

Seeking a Second Opinion - We do not agree that the SEC should require a company that changes independent public accountants to disclose the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the changes. The proposed recommendation is too broad and ambiguous. In any given year, we would expect to hold discussions on any number of accounting or auditing issues which are properly resolved to both parties' satisfaction. Disclosure of such discussions would not be helpful to financial statement users, particularly if the company is incorrectly perceived to be receptive to questionable accounting practices. We believe present disclosure requirements of SEC Regulation S-K, Item 304, and Form 8-K, Item 4 are adequate, as they require specific disclosures, including a letter from the former auditors, pertaining to disagreements between the company and former auditor in connection with audits of the two most recent fiscal years and interim period(s) preceding the change.

Quarterly Reporting - With respect to the quarterly reporting process, we believe there would be little or no benefit resulting from requiring audit committee approval prior to public release. It is our belief that most companies operate similar to ours, in which the board of directors reviews quarterly results prior to release; therefore, a separate audit committee review would essentially duplicate the board of directors' review.



RECOMMENDATIONS FOR THE INDEPENDENT PUBLIC ACCOUNTANT

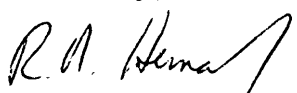
The enhanced role of the public accountant, as recommended by the Commission, naturally leads to a concern about increased audit fees. The recommendations requiring the auditor's report to provide reasonable but not absolute assurance that the audited statements are free from material misstatements is a positive step. However, certain of the remaining recommendations, such as reviewing quarterly financial data and evaluating internal accounting controls, may not be cost effective.

Improving Detection Capabilities - We do not believe the SEC should require independent public accountants to review quarterly financial data of public companies prior to release. We are concerned that mandating a quarterly review prior to release of financial data would lead to more comprehensive audit procedures which would increase fees as well as delay the release of financial data.

Communicating the Auditor's Role - We do not agree with the recommendation to revise the auditor's standard report to describe the extent to which he has reviewed and evaluated the system of internal accounting control, and for the Auditing Standards Board to provide explicit guidance for the auditor's report to address any disagreement with management's assessments, as stated in management's report. We believe the current auditing standards, which require the independent public accountant to make a preliminary review of the system of internal accounting control and decide upon the extent of reliance thereon and the tests and evaluations to be made, are adequate. We are convinced that the recommended change would result in expanded auditing procedures and resultant increased fees with no real benefit to the public.

RECOMMENDATIONS FOR THE SEC AND OTHERS
TO IMPROVE THE REGULATORY AND LEGAL ENVIRONMENT

The thrust of the recommendations is to provide additional enforcement remedies, i.e., civil money penalties, cease and desist orders barring or suspending corporate officers and directors, etc. We agree that the SEC must have adequate enforcement remedies to carry out its charge; however, we believe that adequate enforcement remedies already exist. The SEC has the authority to suspend trading in stock and seek injunctions against fraudulent activity and manipulations of stock prices. We have a serious concern that giving nonjudicial enforcement tools to regulatory agencies has proven in some cases to be detrimental to due process because of overzealous enforcement practices.

Sincerely,

Robert M. Hernandez
Senior Vice President &
Comptroller



A PROFESSIONAL CORPORATION

June 24, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Commissioners:

The members of the Accounting and Auditing Procedures Committee of the Virginia Society of Certified Public Accountants submit the following comments on the exposure draft of the "Report of the National Commission on Fraudulent Financial Reporting." The comments address the complete set of recommendations as presented in Appendix A to the exposure draft.

The Committee supports the recommendations for the public companies, except we feel these recommendations should not apply to small publicly held companies, however you define small. We feel the lack of resources and manpower of many small publicly held companies would make the implementation of these recommendations very burdensome and possibly impossible.

The Committee's views on the recommendations for the independent public accountants are as follows:

Recognizing Responsibility for Detecting Fraudulent Financial Reporting:

The Committee supports this recommendation.

Improving Detection Capabilities:

The Committee supports these recommendations.



Improving Audit Quality:

In connection with the first recommendation in this section regarding mandatory peer review of audit engagements of all public company clients new to a firm, we do not believe "all" such engagements should be required to be examined. We feel this could potentially force the peer review team to examine very few engagements other than the first audits of new clients. This requirement could also force the peer review engagement time to be unnecessary lengthened. We feel the peer review team should be allowed to use their professional judgement in selecting certain first audits of new clients, but not be forced to examine all first audits.

Regarding the second recommendation in this section concerning second partner review, we feel the third point requiring the concurring review partner to consider himself a peer of the engagement partner be eliminated. If not eliminated, we feel the accounting firm should be responsible for assigning a proper concurring review partner, and not make this the responsibility of the concurring partner.

We feel the third recommendation in this section which reads that public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality should be addressed to the public companies. We believe these pressures are caused by forces outside the accounting firms control. Accounting firms should seek help from their clients, the SEC, educators and the financial community because all of these groups are responsible for these pressures. We feel the requirement to handle these pressures should not rest with the accounting firms alone but in unison with the audit committee of the public company clients.

Communicating the Auditor's Role:

The Committee supports the first recommendation in this section.

In connection with the second recommendation regarding the review of internal control, we feel the first sentence in this paragraph should be eliminated. It is our opinion that the communication of the extent to which a public accounting firm has reviewed and evaluated internal accounting controls could not possibly be understood by the average investor. We feel this requirement would only widen the "Expectation Gap."

64b

National Commission on Fraudulent
Financial Reporting
June 24, 1987
Page Three

Reorganization of the Auditing Standards Board:

The Committee feels the Board's current size should be retained, but membership should be allowed to four certified public accountants outside of public practice. Due to the magnitude and complexity of the issues to be handled by the Board, we believe the current size should not be reduced. We also do not understand how individuals who are not certified public accountants can deal with the setting of standards for auditing procedures to be carried out by certified public accountants. This is like having accountants determining the surgical procedures to be performed by surgeons. We would feel more comfortable with surgeons directing surgeons and certified public accountants directing certified public accountants.

The Committee supports the recommendations for the SEC, and the education recommendations.

The comments expressed above are based on the views of the individual members of the Accounting and Auditing Procedures Committee of the Virginia Society of Certified Public Accountants. These comments do not represent an official position of the Society as a whole.

Respectfully submitted,



W. Barclay Bradshaw, CPA
Member, Accounting and Auditing
Procedures Committee of the Virginia
Society of Certified Public
Accountants

WBB/rlz

cc: Mr. Dale H. Strickler, Chairman
Accounting and Auditing
Procedures Committee of the
Virginia Society of Certified
Public Accountants

June 24, 1987

Mr. James C. Treadway, Chairman
The National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania, N.W.
Washington, D.C.

Dear Mr. Treadway:

Having reviewed the preliminary report of The National Commission on Fraudulent Financial Reporting, I feel that, for the most part, it represents a good summary of the things that are already being done by the companies with whom I am associated.

I would like to call your attention to one section, however, that should be corrected. The first two sentences contained in Appendix K on page 183 under the heading "Audit Committee Good Practice Guidelines," read as follows: "An audit committee consisting of independent directors is the primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting."

These two sentences overstate considerably the role played by audit committees -- first of all, very few audit committees meet more than three or four times a year and they rely almost solely on what is reported to them by management, internal audit representatives, and independent certified public accountants, all of whom spend full time performing their jobs and responsibilities. To state that audit committees, which cost the company "peanuts," represent the primary vehicle with regard to the company's financial reporting is absolutely ridiculous and would expose such committees to an unfair burden in litigation resulting from any fraudulent activities which might take place in the bowels of the company.

If these statements are not changed and put in proper perspective, those persons serving on audit committees will have the following options, either change the role of the committee by hiring its own full-time staff to fulfill the role as described above or get off the audit committee. I don't believe that any knowledgeable individual would want to serve on an audit committee and bear the responsibility as outlined by those two sentences without having a full time staff to actually perform those functions. Further, if staffs were hired by the committee, it would precipitate a chaotic

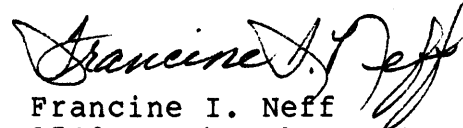
Mr. James C. Treadway
June 24, 1987
Page Two

65a

situation and divide responsibilities at a tremendous expense to the company. If these statements are not corrected, I believe companies will have a very difficult time in getting qualified people to serve on audit committees because of the unwarranted additional liability they would be assuming.

Thank you, in advance, for your giving serious consideration to my letter and my concern.

Very truly yours,



Francine I. Neff
1509 Sagebrush Trail, S.E.
Albuquerque, New Mexico 87123

THE LOUISIANA LAND AND EXPLORATION COMPANY

909 POYDRAS STREET

P. O. BOX 60350

NEW ORLEANS, LA. 70160

(504) 566-6500

RICHARD A. BACHMANN
EXECUTIVE VICE PRESIDENT
FINANCE AND ADMINISTRATION

June 24, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Gentlemen:

We have reviewed the preliminary report of the National Commission on Fraudulent Financial Reporting and respectfully comment on two sentences contained in Appendix K on page 183. Under the heading "Audit Committee Good Practice Guidelines," read as follows: "An Audit Committee consisting of independent directors is the primary vehicle which boards of directors use to discharge their responsibility with respect to the company's financial reporting. An informed and vigilant audit committee represents one of the most effective influences for minimizing fraudulent financial reporting."

We would observe that these two sentences overstate the role played by independent audit committees of boards of directors and could under adverse circumstances expose the committee to unreasonable liability. We would agree that an independent audit committee consisting of outside directors is one of the vehicles when combined with a strong management team, an independent internal audit function and independent certified public accounting team would provide an effective combination of vehicles to minimize fraud in financial reporting.

As you are undoubtedly aware, audit committees do not meet frequently during the calendar year and must, by their very nature, rely upon the integrity and full disclosure of the aforesaid bodies to discharge their responsibilities.

Our concern in highlighting this specific wording, "primary

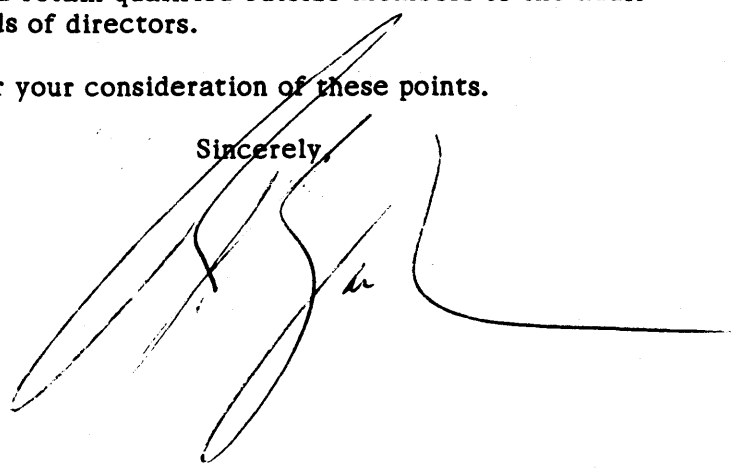
66a

Page 2
National Commission on Fraudulent Financial Reporting
June 24, 1987

vehicle", is in the potential impact that this wording will have in future shareholder litigation and its attendant fallout on a company's ability to attract and retain qualified outside members to the audit committees of boards of directors.

Thank you for your consideration of these points.

Sincerely,

A large, stylized handwritten signature in black ink, consisting of several overlapping loops and a long horizontal tail extending to the right.

RAB:ls

St. Louis County Council

OFFICE OF THE COUNTY AUDITOR



ENGELBERT G. KNAUS, C.P.A.
County Auditor

COUNTY GOVERNMENT CENTER
ADMINISTRATION BUILDING
7900 FORSYTH BOULEVARD
CLAYTON, MISSOURI 63105
889-2076

June 22, 1987

Mr. James C. Treadway, Jr., Chairman
and Commission Members
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Dear Chairman Treadway:

We have been asked by the Local Auditors Sub-Committee of the National Intergovernmental Audit Forum to respond to the May 1, 1987, Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting.

Our group was briefed on May 4, 1987, by Mr. Joseph Donlon of your staff and our consensus was the Report should be expanded to include the government sector as well. We were also able to attend a May 7, 1987, meeting at which Mr. Jack L. Krogstad presented the Disctech, Inc. study. We were surprised at the manner in which we government auditors arrived at much the same conclusions as public/private sector auditors did. It was very apparent the two sectors had a commonality and interdependency of professional interests.

In the last month, we have reviewed the Report as well as the summary article in the June, 1987, Journal of Accountancy and feel the inclusion of some form of public oversight for the governmental sector should be included in the same fashion as your outside Board Members Audit Committee. In many cases, the elected officials do not realize the political impact of their actions on the financial statements and internal control of an organization. In several instances, they believe the auditor has been remiss, when in fact, the prime reason the fraudulent event was uncovered was due to a participant informing an outside authority of the fraud. This was particularly true when it was the top management official responsible for the fraud.

67a

Mr. James C. Treadway, Jr.
June 22, 1987
Page Two

We agree there is a need to better educate the auditor in detecting fraud and inculcating an ethic frame of mind in business and governmental leaders. We believe it is essential that all parties must share more than merely a legal requirement to our fellow man; there is also a moral responsibility not to deceive. In this way, we will eventually remove this cancer of fraud from our business and governmental bodies.

We have not been able to meet to ratify these suggestions, however, we will meet in November in Washington, D. C. and will be available to present your response to the Sub-Committee.

Respectfully,



E. G. Knaus, C.P.A.
Chairman, Task Force
Local Auditor Representatives
to the National Forum

EC:mhs

cc: Mr. Joseph D. Comtois
Mr. Harvey J. Beth
Mr. Norman R. Hawkes
Mr. Roland Malan



Graduate School of Business
Institute of Professional Accounting
1101 East 58th Street, Chicago, Illinois 60637
312|702-7261

June 25, 1987

Dr. Jack Krogstad
Research Director
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Ave.
Washington, D.C. 20006

Dear Jack:

Congratulations on successfully completing the Exposure Draft! I have read it cover to cover; it is an impressive piece of work. I am pleased to have contributed to your effort.

Also, thanks for mentioning my name to people who have inquired about ongoing research in this area (e.g., Baruch Lev). I appreciate the exposure and the opportunity to discuss financial fraud. I have written a paper that compares the financial characteristics of FFR companies with a control group of industry peers for five years preceding the first fraud. Most of the FFR group look like their industry peers five years before the fraud, but they perform worse than their peers three years before the fraud, using profit margin, return on assets and similar measures of performance. A puzzling result is that they look more like their industry peers again in the year before the fraud. I'm still trying to understand this phenomenon. Any suggestions? This paper is still premature for public disclosure, but I'll send you a copy after we perform additional data verification and analysis.

As to commenting on the exposure draft, I believe that the key factor in dealing with fraudulent financial reporting is top management. This is not a novel insight, but I do believe that top management's incentives to be concerned with fraud are based on intrinsic values, not extrinsic penalties. I have studied 159 cases brought by the SEC since 1980, and I have not found the penalties imposed on top management to be particularly harsh, in most cases. (There are exceptions, of course.)

In this vein, I hope the report will discuss at greater length the conflicting incentives faced by top management for whom achieving financial targets results in a favorable impression among financial analysts. In an environment that so strongly emphasizes firm's financial performance, can one really expect top management to make financial fraud a top priority concern? Have you seen Ken Merchant's videotape (for FERF) of the roundtable discussion that we attended?

I saw it recently, and was reminded about the attitude "a little manipulation of accounting numbers is a good thing (for shareholders)." It was believed to be better to manipulate accounting numbers than to play games with actual activities, such as eliminating R&D or deferring maintenance.

The unspoken assumption was that achieving quarterly and annual earnings targets was critical. An alternative view was proposed by Joe Green to run the company as well as possible and let the numbers take care of themselves. That view was not subscribed to by the other practitioners. Can financial fraud be substantially reduced in an environment in which top managers are expected to make the financial numbers look good? I don't think so. Although I believe top management is the key factor in dealing with financial fraud, I believe the problem is rooted in an environment having such a strong emphasis on short-term financial performance. This point is not overlooked in the draft, but I hope it is emphasized more.

During my summary of the roundtable discussion taped for FERF, I found four factors affecting fraud coming from the discussions:

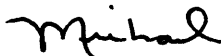
1. Environment conducive to fraud;
2. Incentives to commit fraud;
3. Opportunities to commit fraud (or controls to prevent fraud); and
4. Type of people employed.

A weakness on one dimension can be compensated by strengths on other dimensions. High incentives to manipulate accounting numbers, for example, require more controls, a better environment, and care assessment of the type of people employed.

I have taken the committee's recommendations to educators to heart and begun to write descriptive cases about fraud. I plan to start with my files on SEC actions and court cases, and perhaps expand to public sector cases. Some will be multiple-company descriptions written around a theme such as "the effect of divisional performance incentives on financial fraud;" others will describe single company episodes. I think students, new auditors, financial managers, and executives could learn a great deal about fraud from such cases. I would value any suggestions you have about particular cases, topics, funding sources, etc. (Do you think any of the CPA firms would fund something like this, or is it too sensitive?)

Jack, congratulations on a job well done and a successful two-year stint with the Commission. Are you returning to Creighton? When? As you may know, I am moving to the University of California at Davis (Davis, Cal. 95616) at the end of July.

Sincerely,



Michael W. Maher
Visiting Professor of Accounting
University of Chicago
Professor of Accounting
University of Michigan

MERCK & CO., INC.

P. O. BOX 2000

RAHWAY, NEW JERSEY 07065

June 25, 1987

THOMAS L. OSTERBRINK
CONTROLLER

Mr. G. Dewey Arnold, Executive Director
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Dear Mr. Arnold:

We appreciate the opportunity to express our views on the Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting.

Merck & Co., Inc. ("Merck" or the "Company") is a New Jersey corporation with its principal place of business at 126 E. Lincoln Avenue (P. O. Box 2000), Rahway, New Jersey 07065. Merck is engaged primarily in the business of discovering, developing, producing and marketing products and services for the maintenance or restoration of health.

We generally support the Commission's recommendations as a realistic approach to reducing the risk of fraudulent financial reporting and endorse the overall conclusion that efforts to detect and deter financial statement fraud should be made by all parties involved in the financial reporting process. Merck's responsibility for the integrity and accuracy of its financial statements is evidenced by our current practices which substantially are in accordance with the Commission's recommendations. Additionally, our independent public accountants' practices generally comply with the recommendations. We would like to express our concern, however, on a few specific recommendations, particularly in regard to those which would may change the traditional role of the audit committee.

The audit committee's oversight of management responsibilities is a critical element of the overall control environment and is one of the primary means of preventing fraudulent financial reporting. In order to provide effective oversight, it is critical that the audit committee remain independent. Therefore, the audit committee should not have direct involvement in operating functions or assume direct responsibility for the preparation of financial statements. Certain of the Commission's recommendations may be perceived as shifting these responsibilities from management to the audit committee. As a result, the audit committee's role as an overseer of the financial reporting process may not be preserved.

Mr. G. Dewey Arnold, Executive Director
Washington, DC 20006

69a
June 25, 1987
Page Two

Particularly, we do not agree with the Commission's recommendation for audit committee approval of quarterly financial results. This required approval would encompass responsibility which currently clearly rests with management and would be at odds with the committee's oversight role. The nature and extent of review of quarterly results should be left to the discretion of the audit committee based on its evaluation of financial reporting controls and particular circumstances. Audit committee involvement in the quarterly financial reporting process may be appropriate only when they have determined that a significant risk may exist for irregularity or error or when unusual circumstances occur.

The recommendation to include a separate, signed letter from the audit committee chairman in the annual report is not necessary. The audit committee's reporting requirements are to the board of directors which is in turn responsible for ensuring that they are meeting their responsibilities. A comprehensive letter in the annual report would not enhance the audit committee's role or improve the public's understanding of their relationship to the financial reporting process. On the contrary, such a letter may create the perception that the audit committee is accountable for the financial statements and, likewise, result in a shift in focus away from management's responsibility. The delineation of activities in a letter as suggested by the Commission may result in risk of additional legal liability for the individual audit committee members. In light of the potential increase in liability along with the perceived expanded role of the audit committee, it may become increasingly difficult to attract qualified individuals to serve as committee members.

We commend the Commission on its research and documentation and would be glad to further discuss our comments with you.

Sincerely,

THE UPJOHN COMPANY

KALAMAZOO, MICHIGAN 49001, U.S.A.

June 25, 1987

WILLIAM U. PARFET
Vice President and Treasurer
TELEPHONE: (616) 323-4133

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, DC 20006

Gentlemen:

The Upjohn Company appreciates the opportunity to present our views on the April 1987 Exposure Draft entitled, "Report of the National Commission on Fraudulent Financial Reporting". We applaud the Commission's efforts and acknowledge the comprehensive nature of its recommendations. We agree with the Commission that public companies, their independent public accountants, the SEC, educators and others should take steps to enhance the integrity and reliability of financial reporting.

Generally, we agree with the Commission's recommendations. Furthermore, The Upjohn Company is presently conducting many of its financial reporting activities in concert with the Commission's recommendations for public companies. In the remainder of this letter we have identified six of the Commission's recommendations that, based on our experiences and circumstances, we believe should be changed or modified. While we understand that the Commission views this report as a package, we do not believe our suggested changes would reduce the Report's effectiveness.

Recommendation: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

We agree that our objective should be to prevent and detect fraudulent financial reporting. However, we believe that any system of internal controls is only capable of providing reasonable assurance that fraudulent financial reporting will be prevented from occurring or be detected when it does occur. As the Commission points out, fraudulent financial reporting will continue to exist, hopefully to a lesser degree, even if all of its recommendations are followed. For these reasons, we suggest that the Commission incorporate the concept of "reasonable assurance" in this recommendation.

Recommendation: Public companies should ensure that their internal audit functions are objective.

We do not believe that the chief internal auditor needs to report to the CEO as long as he has free access to the CEO. As the Commission acknowledges, reporting to the CEO may not be practical in a large organization. Furthermore, we do not believe that the chief internal auditor must be an experienced audit professional if his staff has this training. We believe that his skills in terms of communication with others, management of people and conflict resolution are more important than audit training, if his staff can compensate for this prerequisite.

Recommendation: All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it at least annually, and modify it as necessary.

We believe periodic review is adequate, especially if the charter is to be modified as necessary. Absent unusual circumstances it would seem that less frequent review would be appropriate.

Recommendation: The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

We believe that the audit committee should review all services after-the-fact, but only approve major engagements in advance.

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

We disagree with the nature of this recommendation, especially since the duties of the audit committee are described in existing proxy statement disclosures and are usually included in "management's report on responsibility for financial reporting" contained in the annual report to shareholders. We do not object to a voluntary initiative by the audit committee chairman in this regard or the inclusion of the audit committee's duties in management's report. However, we do not see the value of requiring another signed statement in the annual report to shareholders - in addition to the statements signed by the CEO, CAO and independent public accountants.

Recommendation: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We strongly disagree that the audit committee should approve quarterly financial results prior to public release. We do comply with this recommendation at year-end, but we do not believe it is practical or necessary at the three unaudited quarters.

It is our opinion that the Commission's recommendation for independent public accountant involvement prior to the quarterly public release of data is an adequate and appropriate procedure. The independent public accountant has access to the audit committee and can bring quarterly matters to their attention on an exception basis. Therefore, approval of quarterly financial results by the audit committee prior to public release is, in our opinion, unnecessary. The audit committee should be able to adopt those procedures they believe appropriate in light of their individual circumstances.

Conclusion:

We commend the Commission on an excellent report and fully support their objectives in the pursuit of improved financial reporting. Hopefully our comments will be useful to you. They have been offered in a cooperative spirit with the intention of enhancing private sector initiatives in financial reporting.

Very truly yours,

W.U. Parfet
W.U. Parfet
Corporate Vice President
and Treasurer

WUP:rem



71

Howard Hughes Medical Institute

Graham O. Harrison
Vice President & Chief Investment Officer

6701 Rockledge Drive
Bethesda, MD 20817
(301) 571-0210

June 25, 1987

National Commission on Fraudulent Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

I have recently read the summary of your Exposure Draft and intend to read the complete document. As the Audit Committee Chairman of two publicly listed companies, General Re and Property Capital Trust, the material is of intense personal interest. As the Chief Investment Officer of the Howard Hughes Medical Institute portfolio, it is obviously of concern in our own investment policies.

The basic thrust of your extensive review and the recommendations are laudable and display significant staff and Commission member effort. However, the goal of "practical, reasonable in the circumstances, justified by the benefits" does not seem applicable to the proposed requirement of formal Audit Committee approval of quarterly financial statements.

As an investor, I recognize the focus by many on such quarterly reports and the impact they may have on security price movements or creditor attitudes. However, the staging of an Audit Committee meeting prior to each quarterly financial filing is not a practical or necessary activity for any corporation whose Board meetings, Board attendance, and already scheduled Audit Committee meetings display active knowledge and understanding of current financial data. As the accountants know, the quarterly data is based on internal procedures, whose substance has to have been reviewed and approved by both the external auditors and the Audit Committee.

Directors, if meetings are held at least quarterly (and in my case a minimum of 6-8 times annually) have available details that would lead to exploration of any unusual trends vs forecast as well as the kind of inquiry that any Director brings to such meetings from his external world contacts. I see no likelihood that any Audit Committee which has established the proper link with the internal audit group would not be aware of significant departures from standard or of failure to recognize and reflect major income or balance sheet changes that may be impending.

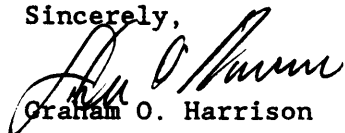
71a

On balance, Director liability and, particularly for those on the Audit Committee, suggests that it is safely left to the discretion of such a Committee to determine the frequency and timing of their meeting, rather than meet to observe a perfunctory pre-release requirement. It is not now easy to find the persons willing to give Board time in the current climate and I believe you would find even fewer willing to travel and change schedule to accomodate a task most would perceive as needless and, indeed, false comfort.

I also find that the concept of a separate descriptive letter in the Annual Report from the Audit Committee Chairman seems needless duplication if the Annual Report includes a standard account of the composition and scope of activity. My responsibility is no lesser nor greater by having my signature with an Annual Report page when I am required to have signed the 10K filing.

Thank you for the efforts you have expended in a world where the charlatans and cheats still abound.

Sincerely,

A handwritten signature in cursive script, appearing to read "G. O. Harrison", written in dark ink.

Graham O. Harrison

HOUSEHOLD INTERNATIONAL

Gaylen N. Larson
Group Vice President
and Controller

June 25, 1987

**National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006**

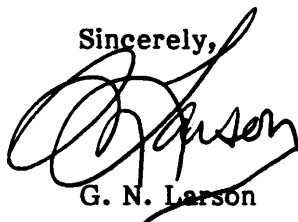
Dear Sirs:

We are pleased to respond to the April, 1987 Exposure Draft of the Commission's report on Fraudulent Financial Reporting. By way of background, Household International has financial services and manufacturing businesses with assets in excess of \$13 billion. Our stock is listed on the New York Stock Exchange. We operate primarily in the United States, Canada, England, Italy, and Australia. Our organizational structure is decentralized with the exception that internal audit and legal functions report on a straight line basis directly to senior corporate management.

Household commends the National Commission on Fraudulent Financial Reporting for the excellent work that has been done in considering the issues and developing the Exposure Draft. We believe this subject should be addressed by the private sector, as you are doing, and that constructive steps should be taken to further strengthen the integrity of the financial reporting process. While we recognize that your recommendations are intended to be considered in their totality, we believe that each should be reasonable and achievable if your efforts are to be broadly accepted and implemented. We are concerned with recommendations that may be unreasonably difficult or impossible to implement or that do not address the basic issue of honest, credible financial reporting. We do not want our directors, management, or employees to be in a position of defending themselves in a court of law or any other forum for failure to implement one or more recommendations where we have concluded they would not appear to further the basic objective of prevention and early detection of fraudulent financial reporting. To that end, therefore, our comments are meant to be constructive and to help your final product become broadly accepted and implemented. Absence of a comment on specific Commission recommendations should be read as indicative of our support.

Our comments are noted in the attached document. Please feel free to call upon us if we can be of further assistance in completion and issuance of your report.

Sincerely,



G. N. Larson

**GNL-0854
Attachments**

Response to the April, 1987 Exposure Draft of the
Commission's Report on Fraudulent Financial Reporting

Recommendations for the Public Company

Internal Controls

External auditors utilize, during examination of their clients' financial statements, a focused "internal accounting control" concept. They can choose to test compliance so as to rely on such controls or to ignore them and opine based on substantive testing. Managements also are expected to opine in annual reports on internal controls defined much more broadly, and to have a sound and adequate basis for such opinions. CEO's are expected, based on your recommendations, to gain an understanding of controls the independent auditor plans to rely on and the basis for any decision not to rely on some or all of those controls. CEO's also are expected to decide whether or not to ask external auditors to evaluate internal accounting controls more extensively as a part of their examination of the financial statements. Further, it is suggested that CEO's may want to periodically engage independent auditors to examine internal accounting controls on an even broader basis and ask that they publicly opine on adequacy of accounting controls.

Managements should have the comfort of knowing that their public representations regarding internal controls are routinely backed up by reviews and compliance testing by both internal and external auditors. Managements should not be placed in a position where external auditors examine only those controls which meet the narrower definition of accounting controls and, through compliance testing, are selected to help them complete field work in fewer hours. Managements and audit committees also should not be required to second guess the extent of independent auditor testing and reliance on controls. More importantly, burdens should not be placed on users of financial statements by requiring that they understand various internal control distinctions and evaluate adequacy of testing and reporting on controls by managements and external auditors.

For the purpose of management reports and opinions of independent public accountants, we therefore conclude that identical definitions of internal control should be utilized. While systems to minimize risks of fraudulent financial reporting as well as more classically defined systems of internal accounting control should be rolled into such definitions, explicit public reporting by all parties should focus on controls that are relevant to overall fair presentations of financial statements.

Accounting Functions

Page 32 contains recommendations concerning maintenance of accounting functions in public companies that can effectively meet their financial reporting obligations. This section of your report could be strengthened by addressing reporting relationships and communication in decentralized operating environments and by encouraging audit committees to review appointment and dismissal,

qualifications, and compensation of the chief accounting officer. While communication with the chief accounting officer is mentioned on page 37, we encourage the Commission to be more specific by recommending that audit committees meet privately with chief accounting officers at least once each year to discuss his or her satisfaction with financial reporting and control environment.

External Voluntary Membership Organizations

Page 33 includes a recommendation that public companies encourage their accounting employees to support organizations such as the Financial Executives Institute ("FEI") and the National Association of Accountants and to adhere to their codes of conduct. We believe this is a toothless recommendation. While the idea has been discussed at high professional and regulatory levels, the thought that when conflicts develop an employee would resign from his present job to avoid conflict with an external voluntary membership organization's code of conduct or drop membership in such organizations would seem to be unrealistic.

IAA Standards

Page 33 includes a recommendation that public companies consider adopting Institute of Internal Auditors ("IIA") standards. Objectives of internal audit organizations are not, and we think need not be, entirely consistent among public companies. We have concern with the extent of due process which the IIA has followed in adopting present standards. If they are to be elevated in status, we suggest the Commission focus more on how those standards have been and will be established. Managements and other interested parties should have an important, formalized due process role in establishing these standards if they are to agree with the resulting cost and scope of internal auditing activities.

Peer Review of Internal Audit Functions

Page 33 includes an endorsement of periodic external peer reviews as a way to enhance effectiveness of internal audit functions. We question the value and cost of such reviews. We prefer that independent certified public accountants be required to annually issue to their clients letters containing ideas and recommendations on how to improve internal audit organizations' effectiveness and to discuss such letters with audit committees. Since independent auditors already are required to review internal audit organizations before they can place reliance on their work, this would seem to be a much more cost effective and efficient alternative.

Auditor Reporting Relationship

On page 34, the report gives the impression that a reporting relationship of the chief internal auditor to someone other than the chief executive officer is second best. We believe objectivity and independence of the internal audit function are achieved not so much in the administrative reporting relationship as in ensuring there is open and unrestricted access of the chief internal auditor to the CEO and Audit Committee. Furthermore, the organization should ensure that internal auditors have unrestricted access to all operations, records, and personnel that are

relevant to their work. We believe the Commission should not attempt to prescribe the reporting relationship for the chief internal auditor, but rather should require that informed managements and audit committees assume responsibility for reviewing and endorsing reporting relationships.

Internal Audit at Corporate Level

Page 35 contains a recommendation for appropriate involvement by the internal auditors at the corporate level. This recommendation is vague and likely to result in inconsistent compliance. The Commission, or perhaps the IIA, should more clearly define the corporate level role of internal audit functions and provide recommendations that can be broadly accepted and implemented by public companies.

Letter by Chairman of Audit Committee

Page 37 contains a recommendation that chairmen of audit committees write letters for inclusion in annual reports to stockholders describing committee activities and responsibilities. We do not support this recommendation. Annual reports already include reports by independent certified public accountants and are to include reports by management. We see inclusion of a third report as serving little or no useful purpose in preventing fraudulent financial reporting. We believe the requirement would lead to inclusion of defensive language in annual reports developed by attorneys to protect audit committees from assumption of unnecessary legal risks. Our company's annual report already includes a page (copy attached as Exhibit 1) which describes the role of various committees of the Board. We also discuss the audit committee's role in our Management Report (copy attached as Exhibit 2). We believe these disclosures adequately communicate the Audit Committee role to our shareholders and see no reason to add a further letter dealing with the subject.

Management Advisory Services

Page 38 includes a recommendation that audit committees approve management advisory services in advance. We believe that quick access to such knowledgeable and skilled resources can be an invaluable resource for managements. We know of no situation where such services have affected external auditors' independence. We suggest, therefore, that language in the Commission's final report clearly accept practices where audit committees establish as a matter of policy the types and general order of magnitude of management services that could be obtained from independent auditors without advance approval and the types of services that are proscribed unless advance approval is obtained. We believe that after-the-fact reporting of such services is sufficient to enable audit committees to confirm their belief that the external auditors remain independent. We would require advance approval of specific services only in situations where the magnitude of such services exceeds guidelines set by audit committees or include the type of services that are proscribed in the audit committee approved policy.

72d

Second Opinions

Page 42 includes a recommendation that management advise the audit committee when it seeks a second opinion on a significant accounting issue. This area is more than adequately addressed by Statement on Auditing Standards ("SAS") No. 50. The Financial Accounting Standards Board's Emerging Issues Task Force ("EITF") is providing timely guidance on accounting and reporting issues. We believe that audit committee involvement in such issues generally is an overreaction and unreasonable burden on them as well as management. Based especially on our participation in the EITF process, it often is prudent for managements to seek counsel of more than one independent auditor when issues are material and answers in the literature or practice are unclear. We believe it is necessary to inform audit committees of such consultations only where the independent auditor who is reporting on a company's financial statements disagrees or is uncomfortable with management's conclusion on a significant accounting or reporting issue.

Auditor Changes

Page 42 contains a recommendation that public companies, when they change independent public accountants, should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with old and new auditors during the three-year period preceding change. We believe that all material, or potentially material, accounting issues are or certainly should be routinely discussed by independent auditors with their clients but believe very few of these discussions are worthy of separate shareholder reporting. Public disclosures should more narrowly focus on significant disputes over the facts or financial reporting implications of material or potentially material transactions and events.

Quarterly Reporting

Page 42 also includes a recommendation that audit committees increase their oversight of the quarterly reporting process including approving financial results prior to public release. We strongly disagree with this recommendation. It is impractical to schedule audit committee meetings in the small time window when quarterly data is available for senior management review but not yet released to the public. Release of results should not be held up to obtain Board or Audit Committee approval. We also believe it is unreasonable and unfair to expect, as Mr. Treadway has suggested in public responses on this issue, an intelligent telephone review by chairmen of audit committees prior to public release of quarterly financial results. We believe the appropriate answer is to encourage timely quarterly reviews by independent certified public accountants and issuance of written reports to managements and audit committees together with discussions of their observations and conclusions at audit committee levels on an after-the-fact basis at least once each year. Only in situations where significant disputes, contingencies, or uncertainties are encountered would discussions with audit committees prior to public release of quarterly results appear appropriate.

We also point out, based on a recent discussion with other companies represented on the FEI's Committee on Corporate Reporting, that timely reviews apparently are routinely performed at many larger public companies but that the scope of such reviews often is less than that required to comply with statements of auditing standards for Review of Interim Financial Information. If timely quarterly reviews are to be mandated, we believe scope of such reviews should be reconsidered to assure that such services are sufficiently focused so as to be cost effective.

New Body on Internal Control Guidance

Page 43 includes a recommendation that the Commission's sponsoring organizations establish a body to guide public companies on internal controls. If you accept our earlier recommendation that only one definition of internal control is appropriate and if the AICPA accepts your recommendation on page 55 that the Auditing Standards Board ("ASB") be reconstituted, then we recommend the ASB accept this responsibility. While we do not strongly object to your recommendation for a separate body, we believe the matter could be dealt with more efficiently and effectively and on a continuing basis by a reconstituted ASB.

Recommendations for the Independent Public Accountant

Tight Reporting Deadlines

Page 51 includes a recommendation that public accounting firms recognize and control organizational and individual pressures that potentially reduce audit quality and makes specific reference to tight reporting deadlines. While we do not have a clear answer to this problem, we think it is in part associated with audit processes that tend to be bottoms up. Clearly a well-managed process that involves senior partners of independent auditing firms in discussions of key issues on a timely basis is critical. We have seen some tendency for audit partners to delay getting into key issues until their staff has substantially completed and documented compliance with auditing standards and results of substantive tests. We believe your recommendations on analytical review and timely quarterly reviews can help but are concerned with the trend towards increasingly detailed auditing standards that increase such pressure. We suggest, therefore, that more focus be placed on audit management and client planning and communication processes to attempt to discover and resolve more issues sooner. Work done at lower audit staff levels should be utilized primarily as a way of corroborating preliminary audit management conclusions.

Standard Auditor Report

Page 53 includes a suggestion that auditors' reports explain that auditing standards require independent public accountants to communicate to management and boards of directors, or audit committees, regarding significant material weaknesses that come to the independent auditors' attention during the audit. We see no reason to explain such requirements to shareholders; the standard report cannot adequately educate readers on all important auditing standards and we believe this disclosure will not add substantive value to such reports. We also take exception to the "significant material" criteria. It is fair for managements to expect independent

auditors to study and take a position on adequacy of internal controls [note absence of the word accounting and refer to our discussion of this subject on pages 1 and 2 of this letter] and compliance therewith. We would strike the "significant material weakness" criteria and recommend use of a lower level criteria such as "substantive" or "important". While senior management and audit committees should not be inundated with trivia, discussion of control problems at senior management and audit committee levels should not be avoided because the auditor thinks better controls might not be cost justified or because deficiencies are not yet "significantly material", whatever that is.

Auditing Standards Board

Pages 55 and 56 contain recommendations for reorganization of the Auditing Standards Board to afford a full participatory role in the standard setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice. We recognize the current chairman's (Jerry Sullivan) concerns about the feasibility of adopting this recommendation. We observed reluctance to accept third party input when participating as a member of the former Auditing Standards Advisory Council and believe Mr. Sullivan's publicly expressed idea that this recommendation might be dealt with by placing some interested outsiders on the Planning Subcommittee also would not work. While we believe the Commission's recommendations may be difficult to implement, we believe you are on the right track and support retention of this recommendation in your final report.

**Recommendations for the SEC and Others
to Improve the Regulatory and Legal Environment**

SEC Regulatory Activities

We agree that a strong and effective regulatory and legal environment plays a critical role in preventing and deterring fraudulent financial reporting. The Securities and Exchange Commission ("SEC") has, on balance, done an excellent job in this area and should continue to be the focal point. We believe the Commission's recommendations relating to Financial Institution Regulatory Agencies should go farther by making specific recommendations on how to expand the scope of the SEC's regulatory activities to directly deal with all business enterprises that can significantly affect public securities markets. Our concern is that the SEC does not have adequate financial reporting and disclosure jurisdiction over (a) certain publicly owned banks, savings and loan associations, and other financial institutions that are subject to disclosure provisions of federal securities laws but report to one of the financial institution regulatory agencies, (b) certain mutual thrift institutions, and (c) other enterprises such as ESM.

Corporate Indemnification of Directors

Household strongly concurs with the Commission's suggestion that the SEC should reconsider its long-standing position that corporate indemnification of directors for securities law liabilities is against public policy and therefore unenforceable. If we are to have strong, effective audit committees, we need an environment that does

not discourage qualified candidates from accepting such responsibilities. We believe this is especially important if we are to expand use of independent audit committees to the many business enterprises that presently do not have such functions or cannot recruit qualified independent persons for such roles.

State Boards of Accountancy

Page 70 includes a recommendation that state boards of accountancy should implement positive enforcement programs that periodically include review of the quality of services that independent public accountants render. With 50 states and four other jurisdictions administering laws governing various aspects of the public accounting profession, we seriously doubt that this recommendation will be adequately responded to. We suggest, therefore, that some type of nationalized approach be taken that more likely will be implemented on a timely, consistent basis.

Standards for the Professional Practice of Internal Auditing

Earlier in our letter, we expressed concern that standards for professional practice of internal auditing promulgated by the IIA not be adopted unless they are subjected to appropriate due process procedures. We believe that blindly adopting IIA standards could impose inappropriate changes on many internal audit organizations and expose companies that do not adopt such standards to unnecessary litigation risks. We also believe some of these standards have little or no relevance to the subject of fraudulent financial reporting. An example of standards which we believe may be unrealistic for many employers to adopt are:

220.02 - The internal auditing department should have employees or use consultants who are qualified in such disciplines as accounting, economics, finance, statistics, electronic data processing, engineering, taxation, and law as needed to meet audit responsibilities.

340 - Internal auditors should appraise the economy and efficiency with which resources are employed.

340.02 - Audits related to the economical and efficient use of resources should identify conditions such as underutilized facilities, nonproductive work, procedures which are not cost justified, and overstaffing and understaffing.

Audit Committee Good Practice Guidelines

Internal Controls

We believe one of the most important objectives of quality audit committees is to review internal controls. This requirement appears to be missing from the Commission's guidelines.

72h

Management Representation Letters

The requirement that audit committees review letters of management representations would appear to be a waste of time in most cases. We believe it is more appropriate to require management or the auditor to discuss with the audit committee any unusual representations or disputes relating to representations requested by independent auditors.

Federal Income Tax Accruals

Post-audit review of items related to federal income tax accruals would seem to be adequately covered under the third bullet on page 185 in your draft dealing with existence and substance of significant accounting accruals, reserves, and estimates. Audit committee records often are reviewed by tax examiners and we believe many audit committees would be especially concerned about documenting compliance with a specific tax liability guideline.

Auditor Association With MD&A

We recognize importance of Management Discussion and Analysis sections in annual and quarterly reports and believe independent auditors should continue to be associated with such disclosures but should not become involved in expressing opinions thereon. We are concerned both about the cost and risk of reducing rather than improving quality of disclosures when they are subjected to detailed rules that would be necessary to allow independent auditors to become sufficiently comfortable and be able to render positive, formal opinions on such disclosures. We believe a practical and cost effective alternative is to suggest that audit committees discuss with independent auditors their impressions of the quality of these disclosures and seek out their ideas on how such disclosures could be improved. We view this approach as a constructive service effort, as opposed to a formal attestation process, and believe many independent auditors already perform such procedures. Your guideline on the top of page 186 could easily be modified to incorporate this concept.

Good Practice Guidelines for Management's Report**Not Misstated Due to Material Fraud or Error**

We object to stating the concept that management is responsible for preparing financial statements that are "not misstated due to material fraud or error". We find this statement to be negative and are concerned that it may lead to the perception that immaterial fraud and error is acceptable. In the same section of the Commission's recommendations, we see a blanket statement that other information in the annual report "is correct". The historically acceptable wording "fairly presents in all material aspects" remains the most appropriate way to communicate such assurances.

72I

Miscellaneous Contents

The Commission suggests on the bottom of page 187 and top of page 188 several topics that management may wish to discuss in management reports including:

- Data that were made available to the independent public accountants,
- Validity and accuracy of representations made to independent public accountants,
- Reporting relationships within the company,
- Uncertainties whose resolution could have a material impact on the financial statements.

We believe little or no value would be added by including such discussions in our management report. As to uncertainties, we cannot imagine users of financial statements looking to management reports for such disclosures. The most appropriate place for material uncertainties to be discussed is in footnotes to financial statements and MD&A's.

Signature

We note that the illustrative management report excludes signature of the chief accounting officer as recommended on page 39 of the Commission's recommendations and presume that this merely is an oversight in preparing the exposure draft.

Supporting Processes

It is relatively easy to publish management reports but more important to encourage preparers to put systems and procedures in place which assure that concepts embodied therein are working and being monitored. This concept is embodied in the last paragraph of the illustrative report where it indicates that the corporation's code of conduct "is publicized throughout the corporation" and that "the corporation maintains a systematic program to assess compliance with these policies". We suggest, therefore, that the Commission focus not just on publishing such reports but on processes which should be in place to support publishing such reports.

Committees of the Board

Audit Committee

The Audit Committee reviews the corporation's internal controls, financial reporting practices, annual financial statements and the examinations made by internal and independent auditors. This committee consists entirely of non-management directors.

John C. Biegler, *Chairman*
Mary Johnston Evans
Dennis C. Fill
Gordon P. Osler

Finance Committee

The Finance Committee approves the issuance of securities by the corporation and its major subsidiaries and reviews dividend policy.

Gordon P. Osler, *Chairman*
John C. Biegler
Donald C. Clark
Gary G. Dillon
Joseph W. James
Lewis W. Lehr
George W. Rauch

Compensation Committee

The Compensation Committee determines the salaries, bonuses and stock options for senior management. This committee consists entirely of non-management directors.

Miller Upton, *Chairman*
Mary Johnston Evans
Dennis C. Fill
Lewis W. Lehr
Raymond C. Tower

Nominating Committee

The Nominating Committee recommends candidates for board membership, reviews board size and composition, recommends changes in board compensation, and reviews management succession and development plans.

Raymond C. Tower, *Chairman*
Donald C. Clark
Miller Upton

Executive Committee

During intervals between board meetings, the Executive Committee, with some exceptions, may act for the board.

Arthur E. Rasmussen, *Chairman*
Donald C. Clark
Gordon P. Osler
George W. Rauch
Miller Upton

Arthur E. Rasmussen, as Chairman of the Executive Committee, is also an ex officio member of the Audit, Compensation, Finance and Nominating Committees.

Management's Report

To the Shareholders of Household International, Inc.

Management is responsible for the preparation, integrity and objectivity of the company's financial statements. Such statements are prepared from the company's books and records of transactions recorded in the ordinary course of business and include amounts that are based upon management's best estimates and judgments, all in conformity with generally accepted accounting principles. Financial information included elsewhere in the annual report is consistent with that in the financial statements.

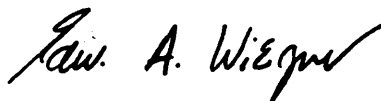
The company maintains systems of internal accounting controls and procedures which management believes provide reasonable assurance that financial records are reliable for preparing financial statements and maintaining accountability for assets. Internal auditors evaluate the adequacy of and investigate adherence to these controls and procedures. Independent auditors also study and evaluate the company's accounting systems and related controls and perform tests of transactions and account balances in accordance with generally accepted auditing standards. This permits them to render an opinion as to the fairness of the company's financial statements.

The Audit Committee of the Board of Directors is composed solely of outside directors. It meets periodically with independent auditors, internal auditors and management to discuss auditing and financial reporting matters. Both internal and independent auditors have unrestricted access to the Audit Committee without presence of company management to discuss results of their audit work and their opinions as to the adequacy of internal accounting controls and quality of financial reporting.

Management has long recognized its responsibility for conducting the Company's affairs in a manner which is responsive to the interests of employees, shareholders, investors and society in general. This responsibility is included in our statement of policy on ethical standards which provides that the company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards. Officers, employees and agents of the company are expected and directed to manage the business of the company with complete honesty, candor and integrity.



D.C. Clark
Chairman of the Board,
President and Chief Executive Officer



E.A. Wiegner
Senior Vice President and Chief Financial Officer



G.N. Larson
Group Vice President,
Controller and Chief Accounting Officer

Independent Auditors' Report

To the Shareholders of Household International, Inc.

We have examined the balance sheets of Household International, Inc. (a Delaware corporation) and subsidiaries as of December 31, 1986 and 1985 and the related statements of income, changes in other shareholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The statements of income, changes in other shareholders' equity and changes in financial position for year ended December 31, 1984 were examined by other auditors whose report thereon dated February 7, 1985 expressed an unqualified opinion on those statements.

In our opinion: the financial statements referred to above present fairly the financial position of Household International, Inc. and subsidiaries at December 31, 1986 and 1985 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of accounting for pensions as described in note 15 to the financial statements, were applied on a consistent basis.

GENERAL MILLS, INC. • EXECUTIVE OFFICES • 9200 Wayzata Boulevard • Minneapolis, Minnesota

June 26, 1987

JAMES D. SMITH
Vice President
Director of Accounting
and Analysis

Mr. James C. Treadway, Jr.
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sir:

We have reviewed your Commission's Exposure Draft on Fraudulent Financial Reporting and generally support your recommendations. Following are comments on some specific recommendations which we think merit consideration.

● Recommendation (For the Public Company):

The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

Comment:

We do not think advance approval of each specific engagement activity is necessary. Instead, we think it would be more appropriate for the audit committee to give advance approval for a budgeted level of expenditure. This budget control would accomplish the desired impact without the administrative burden of individual engagement approvals.

● Recommendation (For the Public Company):

When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three year period preceding the change.

Comment:

While agreeing with the intent, this may be administratively difficult to achieve. We have numerous and continuing discussions (many of which are uncontroversial) with our public auditor in the course of researching accounting and auditing issues. A more practical approach would be to require disclosure of only those issues where you proceeded without agreement of your current auditor and those issues where you obtained a second opinion which differed with your current public auditor.

Mr. James C. Treadway, Jr.
June 26, 1987
Page 2

73a

● Recommendation (For the Public Company):

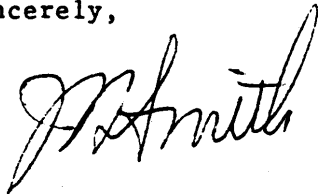
Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

Comment:

We agree that management should keep the audit committee or full board informed and up-to-date on significant matters affecting the company's quarterly financial statements. And, we agree with the audit committee or full Board approving the annual financial statements before they are issued. However, we don't think advance audit committee approval of press releases of quarterly or annual financial results is warranted. The financial community requires timely publication of financial information. We think that if the quarterly or annual financial information is consistent with continuing information which the audit committee has been regularly receiving, advance approval of press releases is unnecessary.

Thank you for this opportunity to comment on this Exposure Draft.

Sincerely,



JDS:ly

311 Harrison Avenue
Massapequa, NY 11758
(516) 799-9290
June 26, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue N.W.
Washington, DC 20006

Re: Comments With Respect to April 1987 Exposure Draft

Gentlemen:

These comments pertain to Chapter Five, Recommendations for Education.

Fraud is essentially a legal issue. When it relates to financial reporting, it impacts upon CPAs and others in the business environment. Thus your recommendations as to weaving this subject matter into management, finance, cost and managerial, systems and auditing courses are valid, appropriate and well-received.

However, why are you ignoring Business Law courses? This is the obvious place where fraud will be thoroughly explored and this course is required for all business students at institutions which are accredited by the American Assembly of Collegiate Schools of Business.

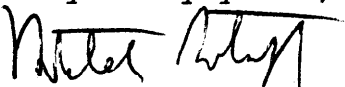
Candidates on a CPA track frequently take more Business Law courses than other students because Business Law is a required segment of the Uniform CPA Examination. It has been this way since June 1917 and, despite 70 years of opposition, will no doubt continue long into the future. As a matter of fact, your excellent report provides strong reassurance that Business Law is a vital subject for CPAs as well as all persons pursuing a career in commerce.

Incidentally, on page 76 where you state that you sampled accounting and auditing textbooks and found little to no discussion of fraudulent financial reporting, this should be no surprise considering your observation on page 80 that professional examinations influence accounting education. Obviously, the discussion you are looking for is appropriately found in the Business Law textbooks which mirror the coverage on the Uniform CPA Examination. Also, please be advised that the CPA Examination is a professional licensing examination whereas the CIA and CMA examinations are merely certification examinations.

If the omission of references to Business Law is unintentional, it should be easily correctable. If, on the other hand, you are attempting to downgrade the importance of Business Law in academia or on the Uniform CPA Examination, you are being intellectually dishonest by not so stating. You are also maligning authors of accounting and auditing textbooks by innocently pretending to observe an unexplained lack of coverage of fraudulent financial reporting.

I hope you will not detract from the credibility of this fine report by getting involved in unrelated issues.

Very truly yours,



MITCHELL ROTHKOPF

MR:ps



75
One James Center
Richmond, Virginia 23219
(804) 782-1427

JAMES ERMER
Senior Vice President-
Finance

June 26, 1987

The National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, NW
Washington, D.C. 20006

Gentleman:

CSX Corporation (CSX) is pleased to respond to the exposure draft entitled "The Report of the National Commission on Fraudulent Financial Reporting."

CSX and its subsidiaries, with total assets in excess of 13 billion dollars, operates in four strategic areas - transportation, energy, properties and technology. The common stock of CSX is listed on the New York, London and Swiss stock exchanges and trades with unlisted trading privileges on the Midwest, Boston, Cincinnati, Pacific and Philadelphia Stock Exchanges.

CSX applauds the National Commission on Fraudulent Financial Reporting (Commission) for a very comprehensive report and set of recommendations with regard to fraudulent financial reporting. We recognize the exhaustive research which has taken place and commend the Commission on a job well done.

As a very large company with many areas of public financial reporting, we feel qualified to address many of the issues discussed in the report. The Company has an audit committee comprised solely of outside directors, a large internal audit staff and represents an extensive engagement for our independent auditors. We deal with the SEC and other regulatory agencies, e.g., the Interstate Commerce Commission, the Federal Energy Regulatory Commission and the Federal Maritime Commission, on many reporting issues.

We find it difficult to argue against many of the theoretical concepts discussed as everyone would like to see fraudulent financial reporting diminished or eradicated. We are deeply concerned, however, with the costs which must be incurred if all of the recommendations were implemented. The potential costs which all companies would bear seems totally out of proportion to the limited number of cases of fraudulent financial reporting the Commission acknowledges having been found.

CSX believes Corporate America must shoulder much of the responsibility and cost for assuring that controls are adequate to reasonably guard against fraudulent reporting, and the emphasis must come from within industry and not from external sources. This

- 1 -

belief coincides with much of the Commission's impetus, however, we envision a much lesser and costly role for the independent public auditor and the SEC. Management, and to a lesser degree the audit committee, are in the best position to prevent fraudulent reporting because of their intimate knowledge of the business and its internal control systems, and they must exhibit the self-discipline to ensure that the job is done. What must be avoided is the additional regulatory bureaucracy which would result if all of the Commission's recommendations are implemented.

The specific recommendations with which CSX disagrees in concept, and our comments, are as follows:

- 1. The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

CSX believes there are already enough regulatory or quasi-regulatory bodies in existence and that, if such guides are necessary, the task can be performed by one of the present groups.

- 2. The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.
- 3. Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

The SEC, in Accounting Series Release 177, recommends, but does not require, the timely review of quarterly data by the independent public accountant. We agree that a timely review seems most appropriate and have followed that policy since CSX's inception in 1980. Whether companies follow that policy or not, however, it is clear that all publicly reported companies must have their quarterly data reviewed prior to year-end. For this reason, we feel that it is unnecessary to recommend that not only the public accountant, but the audit committee, review and approve quarterly earnings prior to release.

From a more practical standpoint, CSX releases quarterly earnings on the first work day after the close of a quarter. It is therefore impossible for our public accountant and/or audit committee to review and approve earnings by the time of release. Because of the early release, every effort is made to ensure that the earnings are correct. In over 30 years of such reporting by CSX and a predecessor company, earnings as

released have not been changed because of post-release audit findings.

4. The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

CSX has consistently followed the policy of having the audit committee annually review the company's use of such services. We believe that management should have the prerogative to utilize the services of the independent accountant when the necessity arises. We certainly agree that the audit committee should be advised of this usage of the public accountant's services, but do not believe that "approval" should be granted in advance. Management alone is involved in the day to day activities of the company and is in the best position to know when the services are needed.

5. All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

CSX does not include such a statement in its annual report because we feel this is inherent in management's responsibility and does not require a written representation. Moreover, many of the management reports we have noted in other companies' annual reports tend to use very general boiler plate language. We believe non-disclosure is superior to this type of report, and doubt if many investors put much credence in such statements.

6. All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

CSX believes this recommendation would produce additional boiler plate language which would only serve to increase the amount of information in annual reports, but add no value. The primary responsibilities of the audit committee are stated each year in our proxy statement and we see no reason to have a signed statement in the annual report repeating

this disclosure. The audit committee is responsible to the full board of directors and we do not see any more of a necessity for a separate report from this committee than from any other committee of the board.

- 7. The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.

CSX has no problem with the Commission's recommendation to revise the auditor's report to describe the extent of review of the accounting controls. Since we disagree with the recommendation that annual reports contain management's reports, we certainly disagree with the auditor's report challenging such a disclosure. Public auditors are paid to opine on the historical financial statements, not on management's assessment of the internal controls. If the audit cannot be completed to the satisfaction of the auditor because of the controls, his report should be qualified. The auditor should not be asked or forced to opine on a management representation.

- 8. Chapter four contains several recommendations with regard to additional SEC enforcement remedies, increased criminal prosecution and SEC resources. The following response addresses our concerns on that group of recommendations.

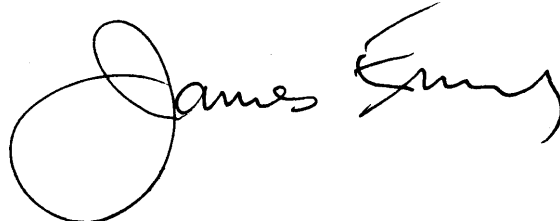
CSX believes that these recommendations go too far, particularly since the Insider Trading Sanctions Act of 1981 has never been fully tested to determine its outer-most limits. Traditional SEC enforcement mechanisms have been fruitful in regulating the financial markets and the SEC has had great success in recent months in indicting and settling insider trading cases. In short, we have no reason to believe that the SEC has less than adequate enforcement authority. There is thus no need for Congress to expand the current enforcement structure of the SEC.

We agree that the SEC should have adequate resources to enforce regulations that help prevent, detect and deter fraudulent financial reporting. Indeed, it seems to us that Congress should seek to solve the problem with additional

resources rather than with an unnecessary expansion of the current regulatory framework. To that end, CSX supports the addition of new personnel to prevent fraudulent financial reporting. We also believe that increased SEC cooperation with the Department of Justice and the several United States attorneys should be sought. Increased intra-agency efficiency, such as joint SEC/Department of Justice taskforces, would greatly enhance current enforcement. With more personnel and resources, the SEC could precisely target those exact areas which require increased monitoring.

In conclusion, CSX disagrees conceptually with only a relative few of the recommendations and supports an increased resource base for the policing of the financial markets by the SEC. We do not, however, agree that Congress ought to expand the current enforcement system and we fear the cost of the Commission's entire package will be exceedingly high. Our impression from the Commission's own statistics is that the vast majority of the fraudulent financial reporting cases have involved smaller companies and/or companies not utilizing national public accounting firms. The vast majority of the costs to be borne if all the recommendations are adopted, however, will be borne by the larger companies which already have many of the proposed items in place, either voluntarily or because their securities are listed on a national exchange. This hardly seems fair. We strongly urge the Commission to revisit the recommendations not only from a cost/benefit standpoint, but also from the standpoint of preventing the unnecessary expansion of the current regulatory framework.

Very truly yours,

A handwritten signature in black ink, appearing to read "James E. Smith". The signature is written in a cursive style with a large, prominent loop at the beginning of the first name.



76

A Business Unit of Clark Equipment Company

June 26, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Commissioners:

First of all, I would like to thank the members of the Commission for the opportunity to comment on this extremely important Exposure Draft. In addition, I would like to applaud the members of the Commission on their efforts to date and state that in general I feel this is an excellent product. Having been in internal auditing for fifteen years and an active participant with the Institute of Internal Auditors on the international level for sometime now, it is very gratifying to see the Commission recognizing the profession of internal auditing as an integral part of the recommended solution to the problem of fraudulent financial reporting.

The purpose of my letter is to address an issue related to the composition of the internal audit function as described in the Exposure Draft. More specifically, the Pre-Exposure of the Commission's Exposure Draft, a speech given by Chairman Treadway in Houston, Texas on November 18, 1986, included the following statement under Section 9, Mandatory Internal Audit Function: "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." However, in reviewing the Exposure Draft, I do not find any wording similar to the second sentence shown above. Even though I do not feel the words "independent auditor" are necessarily the best, I do feel the concept that the responsibilities of the internal audit function may be completely or partially performed by a qualified professional from the outside is very important and should be clearly expressed in the Report. Let me give you some examples which will illustrate my point.

In Section III, on Page 20 there is the statement that "Opportunities for fraudulent financial reporting are present when the fraud is easier to commit and when detection is less likely. Frequently these opportunities arise from ineffective internal audit staffs. This situation may result from inadequate staff size and severely limited audit scope." This certainly addresses a very important point; however, the reality of the situation is that there may be legitimate reasons why a internal audit function may occasionally end up in this dilemma. Since it is quite common for internal auditing to be used as a management training ground, there is regular turnover of the staff resulting in a temporary shortage of personnel to complete the audit plan. Also, sometimes the solution to a company's financial stress is a freeze on hiring or more seriously a reduction in permanent headcount. These actions do not necessarily mean that the company desires any less monitoring of internal controls by the internal audit function. In any of these situations, the audit director may feel that in order to fulfill his responsibilities to management and the audit committee that the use of outside professional services, functioning under his direction, is the appropriate solution. If the Commission finds this solution to be acceptable, it should be clearly stated in the Report.

Page 2

Another example to illustrate my point will address the qualifications of the internal audit staff. In the Exposure Draft on Page 33, the Commission has recommended, "Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company." Excellent recommendation; however, I contend that to some extent the smaller publicly held companies may have a hard time satisfying this requirement. The smaller the staff size, the more limited will be the variety of experience and expertise among the group. Yes it's true these companies may be less sophisticated; however, there is a minimum level of sophistication in such areas as inventory control, management reporting, accounting and electronic data processing which are necessary just to stay with the competition. What the audit director may need in order to adequately complete the audit plan is only a limited amount of auditing each year in certain specialty areas. He may decide to establish a core group of auditors and fulfill his specialty requirements by using the services of a qualified professional from outside the company who has the expertise needed. If the Commission considers the audit director's action to be acceptable in fulfilling the internal audit function's responsibilities, it should be clearly stated in the Report.

These are a couple of examples of when it may be appropriate for an audit director to use qualified professionals outside his company to more effectively fulfill his responsibilities to management and the audit committee.

My assumptions so far have assumed that some form of an internal audit function currently exists in the company. There will also be those companies who do not have an internal audit function and are faced with establishing the function for the first time. This may seem like an overwhelming and expensive task to some companies due to their lack of experience in this area. This may cause a reluctance or delay on management's part to comply with the Commission's recommendations. Management's best reaction may be to bring in a qualified professional outside the company to assist them in defining their internal audit needs and identify the various alternative approaches available to them to establish an effective internal audit function. The best alternative may be to establish their own internal function immediately, go through a phase-in period for establishing their own function with temporary assistance from the outside qualified professional or just to use the outside qualified professional to provide the audit function for them. If the Commission considers these approaches acceptable methods of establishing an effective audit function, this should be clearly stated in the Report.

In summary I would like to say that if the Commission wishes to encourage companies to establish or expand their internal audit function for more effective monitoring of internal controls and financial reporting, the Commission should modify the Report to clearly identify the primary acceptable avenues available to the company for compliance with the Commission's recommendations.

Therefore, I would recommend that a statement be added to Chapter Two, Subsection III-B, Internal Audit Function and Chief Internal Auditor, as follows: "The function can be provided completely or in part by a qualified professional auditor outside the company who meets the same qualifications as defined for the internal audit function." The statement includes "a qualified professional auditor" instead of independent auditor because there are many individuals qualified to perform this service who are not in public accounting. In addition, use of these professionals may in fact be preferred since many of them are not chartered to certify the company's financial statements and therefore may represent a more independent opinion. A related issue was addressed by the Commission on Page 39 of

the Exposure Draft in discussing the results of two recent studies, a Harris survey sponsored by the AICPA and a research report prepared for the AICPA's Public Oversight Board. The studies "showed that a substantial percentage of members of the key public groups involved in the financial reporting process believe that performing certain management advisory services can impair a public auditor's objectivity and independence."

Let me express that my comments in this letter are based upon my personal experiences in the profession of internal auditing. The firm with whom I'm employed, Clark Management Services Company, provides the internal audit function for Clark Equipment Company, a Fortune 500 company. In addition, we provide our services to other companies on a contractual basis. Our support to their audit efforts has included such specialties as providing professional auditors with foreign language capability and EDP technical expertise; qualifications which these companies could not afford (nor did they need) to retain on their permanent staffs. I feel we have provided highly qualified professional services to these companies which has allowed them to accomplish a much more effective internal audit program and provide their management and audit committees with a more comprehensive coverage of the financial reporting; something we in the profession and you on the Commission are striving for.

Once again, I thank the Commission for the opportunity to comment on this Exposure Draft. I hope that you find my comments to be valuable input as you progress towards a final Report. If you should desire any further discussion of this matter, please contact me at your convenience. I can be reached at (219) 282-3985.

Best regards,



Donald E. Zervas
Vice President



David N. McCammon
Vice President-Controller

Ford Motor Company
The American Road
P.O. Box 1899
Dearborn, Michigan 48121-1899

June 26, 1987

Mr. James C. Treadway, Chairman
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue N.W.
Washington D.C. 20006

Dear Mr. Treadway:

We are pleased to have this opportunity to respond to the Commission's Exposure Draft on the Report of the National Commission on Fraudulent Financial Reporting. Ford Motor Company promotes an operating philosophy that stresses the importance of a strong financial control environment, and long before the Commission's Report we initiated many of the specific actions that the Commission proposes. Consequently, we are very interested in this project and we share the Commission's concern that fraudulent financial reporting, although infrequent, could have widespread consequences.

We endorse many of the recommendations in the Exposure Draft and specifically support the Commission's conclusion that improvement can be made in all areas involved in the financial reporting process. We also agree that the recommendations for improvement must be cost-effective. Finally, we favor recommendations that will result in measurable improvement in financial reporting as compared with those that may be adopted as a matter of protocol.

Although we support the overall thrust of the Commission's Report, there are several recommendations in the Exposure Draft that we are not convinced will contribute to reducing the incidence of fraudulent financial reporting. There also are specific features of several recommendations that would, in our view, impose an undue burden in compliance. We have addressed these items in the following comments.

77a

Recommendations for Public Companies

Comments on specific recommendations for public companies follow.

Applicability of Recommendations

The Exposure Draft is unclear as to whether a wholly-owned subsidiary would be subject to the recommendations if it had publicly traded debt securities and therefore filed periodic reports with the SEC (or other federal regulatory agencies). We do not support application of the recommendations to wholly-owned subsidiaries because they are subject to control by the parent company. This requires clarification in the final report.

Maintenance of Adequate Internal Controls

We believe that maintaining an adequate system of internal controls should be a fundamental objective for all companies. It is possible, however, that "adequate internal controls" could be interpreted as providing 100 percent prevention, which clearly is cost-prohibitive. We recommend that the concept of "reasonable assurance" be incorporated specifically into the wording of this recommendation.

Code of Corporate Conduct

We support the intent of the recommendation for all companies to adopt a corporate code of conduct. We do not believe, however, that employees at all levels need to participate in development of the code to assure understanding of and adherence to it. In addition, although we do not oppose automatic distribution of the code throughout a company, we favor an alternative that would rely upon management's judgement to distribute the code to employees in positions exposed to situations in which improper conduct could result in a violation of the public trust.

Written Charter for the Audit Committee

We agree that the Audit Committee should have a written charter setting forth its duties and responsibilities and that companies should provide for modification of the charter as necessary. We question the need for an annual review of the charter by the Board of Directors, however, because the duties of the Audit Committee are generic and not subject to frequent change. The recommendation establishes an unnecessary requirement in this regard.

Audit Committee Prior Approval of Management Advisory Services

We believe management advisory services to be rendered by a company's independent public accountants should be approved in advance by the Audit Committee to the extent possible and practical. We suspect, however, that the recommendation in its present form could be unnecessarily restrictive and inhibit management flexibility in cases where quick action is needed. We propose the addition of wording that recognizes instances in which delegation of approval authority is appropriate (small dollar value engagements, for example) with after-the-fact review with the Audit Committee.

Management Report in the Annual Report

We support the provision for a management report in the annual report to stockholders. Ford Motor Company has included a statement concerning management's responsibility for the financial statements in its annual reports since 1977.

We believe, however, that the present voluntary system should be continued and that issuers should have flexibility to tailor the statement to fit individual company circumstances. We are concerned that establishment of strict rules for the statement, including a requirement that it be filed with the SEC, would of necessity require the active participation of the company's lawyers in the drafting of the statement, possibly resulting in a rigid and "defensive" format and ultimately diminish the statement's value.

We do not support signing of the report by the chief executive officer and the chief accounting officer. The "Message to Stockholders" currently is signed by the senior-most executives in the company in most annual reports. Separate signing of the management statement is redundant and may imply a different level of representation if signed by different parties.

We do not favor including an evaluation of the company's internal control system in the management report. We believe that it is adequate for a company to make the assertion that management maintains a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial statements. If an evaluation of the internal control system is required, we believe it would have more credibility if rendered by the independent public accountant. We expect, however, that this could result in a considerable increase in auditing effort and fees -- that would not be justified by the benefits derived. Consequently, we do not support this recommendation. Further, requiring a statement on the effectiveness of the internal control system at a point in time may imply that the system is not effective at other times. We suggest that the reference to a point in time be excluded.

We also do not support including a statement that management has considered recommendations made by the auditors concerning the system of internal control, and has responded appropriately. We believe that reacting to identified internal control deficiencies, regardless of who identifies them, is inherent in maintaining an internal control system. If lack of management's responsiveness became a serious issue, we believe that it is within the auditor's regular responsibilities to bring it to the attention of the Audit Committee and stockholders.

Audit Committee Chairman's Letter

We do not support the requirement for a letter from the Chairman of the Audit Committee describing the committee's responsibilities and activities in the annual report. The recommendation duplicates much of the existing proxy statement disclosures without, in our view, a perceived benefit.

Change in Independent Public Accountants

We agree that a change in public accountants should be disclosed -- but it is unclear how this recommendation differs from existing Form 8-K disclosure requirements concerning changes in auditors. If this recommendation is not fundamentally different than existing requirements, we would favor retaining the present form.

Audit Committee Oversight of Quarterly Financial Reporting

We believe that other provisions of the Commission's Report provide sufficient oversight capabilities for the Audit Committee without imposing a requirement of the review of quarterly results prior to release to the public. A system of ongoing communication with the Audit Committee covering financial results and an "open door" policy between the independent accountants and the Audit Committee provide better means for the Committee's members to discharge their responsibilities. Further, we are concerned that this requirement would blur the distinction between the Audit Committee's oversight of and participation in the financial reporting process.

We agree with the Commission that financial statement users rely heavily on quarterly financial statements. Scheduling Audit Committee meetings to coincide with the release of quarterly results is unduly restrictive, however, and we would not support holding separate meetings solely for this purpose. Instead, we believe the results of the independent public accountant's quarterly reviews can be communicated to Audit Committees after the fact. We cannot support a measure that could delay release to the public without appreciable gain.

PL

Setting Standards for Internal Control

We believe that existing authoritative bodies, the ASB, IIA, AICPA, and FEI, are sufficient and do not support the establishment of another governing body.

Recommendations for Independent Public Accountants
--

We support revisions to auditing standards and practices that improve audit and financial reporting quality. At the same time, revisions to auditing standards should be justified by the benefits received. They should not impose undue burden to the accounting profession or audited companies. We believe that the ASB has responded to key issues raised in the Commission's report through the ten proposed auditing standards that were recently released. We are interested and will follow the responses received by the ASB to the proposed standards and the reaction of the Commission to those comments.

We support self governance of the accounting profession. To the extent that the recommended restructuring of the ASB strengthens self governance and auditing quality, we support it as well. We believe that if the ASB is reorganized as recommended, care should be taken to ensure appropriate representation by all interested parties -- industry, government, and education -- rather than just one interest group.

Recommendations for Education

We support the proposals that ensure that business students will receive sufficient instruction on fraudulent financial reporting. It is imperative, however, that financial reporting issues be presented with a balanced perspective. Business students should acquire an understanding of fraudulent financial reporting causes, its widespread impact, and cost-effective controls in the financial reporting system, but should not be left with the impression that fraudulent reporting is pervasive. Care also should be taken to ensure that the integration of fraudulent reporting issues into the curriculum is accomplished without sacrificing coverage of other equally critical subject areas.

* * * * *

June 26, 1987

Ne

To summarize, we endorse many of the recommendations made by the Commission. We believe that the recommendations adopted must be cost effective, avoid duplication with existing standards, and result in measurable improvement in the financial reporting process. Further, it should be kept in mind that the vast majority of American business practice is highly principled. Care must be taken in adopting corrective actions to not impose unduly restrictive or specific measures to solve isolated deficiencies.

We are pleased to have this opportunity to share our comments with the Commission.

Sincerely,



D. N. McCammon



PHILIP MORRIS

COMPANIES INC.

120 PARK AVENUE, NEW YORK, N.Y. 10017 · TELEPHONE (212) 880-5000

June 26, 1987

Mr. James C. Treadway, Chairman
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue N.W.
Washington, D.C. 20006

Dear Mr. Treadway:

We have reviewed the exposure draft which presents the findings, conclusions and recommendations of the National Commission on Fraudulent Financial Reporting.

We are impressed with the organization and thoroughness of the study, as well as with the involvement of a broad segment of the public and private sector, who assisted the Commission in their study and whose comments were utilized by the Commission in formulating their recommendations. The Commission is to be commended for its fine effort in reviewing a very difficult and complex subject and for its achievements as represented by this exposure draft.

The recommendations by the Commission are, for the most part, acceptable to us. However, we do have some concerns which we wish to express:

- ◆ We do not agree with the recommendation that Audit Committees should approve financial results prior to public release (page 42).

Management is responsible for the financial statements. This statement is reiterated in your exposure draft. To involve the Audit Committee in the approval process connotes a shared responsibility which is incorrect and sends the wrong message to the public. The difference between management's responsibility and the Audit Committee's oversight responsibility should remain clear and distinct. The Commission's recommendations would confuse and blur this distinction.

78a

James C. Treadway
Page 2
June 24, 1987

We also foresee implementation problems with this recommendation. Additional Audit Committee meetings will be required, and scheduling difficulties can arise in having Audit Committee meetings timed precisely prior to public release of financial results.

Quarterly financial results are highly confidential and known to very few members of management before public release. We have complete confidence in the confidentiality and discreetness of Audit Committee members. However, as more individuals are involved in the process, the greater the risk of inadvertent disclosure of information.

We suggest that the Audit Committee review the quarterly financial results after public disclosure. This would fulfill the oversight responsibilities of the Audit Committee and accomplish the goals of the Commission.

- ◆ The Commission recommends that public companies include in their reports to stockholders a letter signed by the Chairman of the Audit Committee describing the Committee's responsibilities and activities during the year (page 41). We disagree with this recommendation.

The annual report is management's report to the stockholders. We are in agreement with your recommendation that the annual report should include a management report signed by the Chief Executive and the Chief Accounting Officer. To include an additional report signed by the Chairman of the Audit Committee serves no real purpose. It confuses the reader as to who is responsible for the report and is redundant. It is merely symbolic and is boilerplate, which is what we should try to eliminate.

- ◆ Our final comments concern the Commission's endorsement of periodic external (peer) reviews of the internal audit function (page 33). We support the Commission's desire to enhance the effectiveness of the internal audit function; however, we believe the recommendation is impractical and would be ineffective.

James C. Treadway
June 24, 1987
Page 3

We firmly endorse the efforts of the Institute of Internal Auditors (IIA) to enhance the professionalism of internal auditors. Our audit organization has adopted the IIA standards. We also believe in quality assurance and have an ongoing quality assurance program within our corporate internal audit organization.

External (peer) reviews of the internal audit function are in the embryonic stage of development. There are three approaches that can be utilized to comply with your recommendation. We believe that none of these are acceptable for the reasons stated:

1. External consulting firms expert in quality assurance reviews are either non-existent or are "one man" shops whose capabilities vary considerably.
2. The Institute of Internal Auditors sponsors a quality assurance program conducted by internal audit professionals. These professionals are General Auditors or Managers from the public or private sector who volunteer their services. Although sponsored by the Institute of Internal Auditors, these individuals are employed by specific companies. Utilizing individuals from one or more legal entities to review quality assurance programs of another legal entity is cause for serious concern. This approach raises possible legal and confidentiality questions and problems.
3. Independent public accountants have provided this review as a specialized consulting service. There has been much discussion, pro and con, as to whether or not independent public accountants can or should provide this service. Many internal audit professionals believe that independent public accountants are biased toward their own audit objectives and cannot evaluate an internal audit function. In any event, public accountants tend to use their own quality assurance standards and are not familiar with or apt to accept the IIA's quality assurance standard.

There are no easy solutions to this problem. For this reason, we believe it is impractical to implement an effective external (peer) review of the internal audit function.

78c

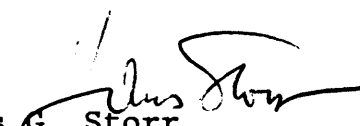
James C. Treadway
June 24, 1987
Page 4

We offer an alternative which is practical and effective:

1. Internal audit functions should be required to comply with two elements of the IIA quality assurance standards --- supervision and internal reviews.
2. Independent public accountants are required to evaluate the competence and objectivity of internal auditors as part of their assessment of internal accounting controls. Please refer to Statement on Auditing Standards (SAS) AU Section 322, paragraphs 5, 6 and 7.

The Commission's draft report indirectly supports the independent public accountant's responsibility to provide this evaluation. Exhibit K of the draft report under the heading "Post-Audit Review" recommends that the Audit Committee should meet privately with the independent public accountant to request his opinion on various matters, including the quality of financial and accounting personnel and the internal audit staff. This recommendation should be restructured to encompass a more comprehensive external review of the internal audit function to be provided by the independent public accountant to management and to the Audit Committee.

We express our appreciation for the opportunity to convey our thoughts and concerns on this extremely important subject. We believe the Commission has conducted an excellent study, comprehensive in all respects, which should have a definite impact on reducing the incidence of fraudulent financial reporting.


Hans G. Storr
Senior Vice President &
Chief Financial Officer

Becton Dickinson and Company
One Becton Drive
Franklin Lakes, New Jersey 07417-1880

(201) 848-6800

**BECTON
DICKINSON**

June 26, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Gentlemen:

This letter is written in response to the Exposure Draft dated April 1987 of the Report of the National Commission on Fraudulent Financial Reporting. In general, our Company applauds the efforts of the Commission on this topic and agrees with most of the recommendations set forth in the Exposure Draft. In particular, we concur that the "Tone at the Top" is the most important element in creating an environment which reduces the potential for fraudulent financial reporting. Also, as your draft report notes in the Summary of Recommendations, some companies presently employ many of the techniques recommended. We believe Becton Dickinson and Company is such an organization and there will be little change in our current practices. However, the Commission has made certain recommendations for public companies which we request be reconsidered.

These recommendations place the Audit Committee in a role which, we believe, is very similar to that of line management. This type of capacity diminishes the independence and objectivity of the Committee. It is our view that the line management of a company is the appropriate level of responsibility to assure fair financial reporting with the appropriate oversight by the independent public accountants. The Committee's role in our opinion is more properly a continuing review to ensure that there has been sufficient involvement in the financial reporting process by the independent public accountants.

We also question the necessity of the Chairman of the Audit Committee providing a separate letter to be included in the annual report to shareholders describing the Committee's activities during the year. We concur that the Audit Committee should be "informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls." However, we believe requiring a letter from the Chairman of the Audit Committee would hold the members of the Audit Committee to a higher level of accountability and suggest that the Audit Committee's role in the governance of our Company is greater than

other Board members and Board Committees. In our opinion, there should be uniform responsibility among our Board members and Committees in providing the necessary oversight of and direction to our organization.

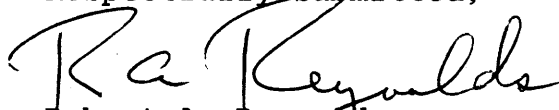
The Commission has also proposed a recommendation with respect to management advisory services provided by independent auditors which, we believe, is overly restrictive on management. We agree that Audit Committees should monitor the potential impairment of independence relating to independent auditors performing such services, although it is our contention that advance approval of routine nonaudit services such as tax consulting and tax return preparation is not practical. Our Company has implemented a procedure whereby nonaudit services for a specific project with estimated fees in excess of \$100,000 requires advance approval from the Audit Committee which, with a recurring audit fee in excess of \$1,000,000, we believe is a reasonable threshold for the Audit Committee to consider the impact on the auditors' independence.

Lastly, we believe the Commission's recommendation regarding the Audit Committee's involvement in quarterly reporting is not consistent with our view as to the appropriate role of the Audit Committee. We currently review quarterly results with our independent public accountants and, although they do not issue a formal review report, we discuss with them any unusual or complex transactions occurring in the quarter and obtain their guidance before releasing earnings information. We believe this process enables them to adequately evaluate the integrity and reliability of interim financial information without delaying the release of information to the financial markets. The Committee's role in our opinion is more properly a continuing review to ensure that there has been sufficient involvement in the quarterly reporting process by the independent public accountants.

In addition to the foregoing, we believe the effort required to coordinate an Audit Committee clearance of quarterly results prior to public release would present severe logistical problems for us since the four directors who comprise the Audit Committee are out-of-state residents. The dates for the regular Audit Committee meetings are established at least a year in advance in order to accommodate the busy schedules of these individuals. The uncertainty of the exact dates that quarterly financial statements will be ready for review would preclude this type of scheduling and, therefore, a delay of several days in the issuance of financial statements could be the result. We do not believe this delay is acceptable, and quick phone calls to the directors would not be a meaningful solution. Furthermore, we do not wish to amend the qualifications necessary for Board membership so as to require geographic proximity to our offices.

We are pleased to have this opportunity to provide our comments on such important issues and congratulate the Commission on its efforts.

Respectfully submitted,

A handwritten signature in cursive script that reads "Robert A. Reynolds". The signature is written in black ink and is positioned above the printed name and title.

Robert A. Reynolds
Vice President and Controller



PENNSYLVANIA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

1608 Walnut Street, Third Floor • Philadelphia, Pennsylvania 19103 • (215) 735-2635

June 26, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

RE: May 1, 1987 Exposure Draft

Gentlemen:

The Pennsylvania Institute of CPAs' Committee on Auditing and Accounting Procedures appreciates the opportunity to comment on the "exposure draft." The size of the task facing the Commission was not lost on our members. We commend the comprehensive nature of the recommendations made.

We are concerned that the Commission limited the scope of its study to public companies. The omission of private companies could lead to some erosion of the Commission's mission of identifying causal factors. Private organizations could have fraudulent reporting causal factors different from and in addition to those of public companies. To overlook this source would be to overlook potential steps to reduce the incidence of fraudulent reporting.

We are skeptical of the potential impact education can have on the ethics of perpetrators of fraud. Ethical values may not be greatly influenced by the expansion of business and accounting curricula.

Additionally, one of our members, William H. Lundquist, has several specific comments we wish you to consider. A copy of his May 27, 1987 letter to me is enclosed.

Thank you for your consideration.

Sincerely,

John T. Crawford, Chairman
Auditing and Accounting
Procedures Committee

JTC:s1m
Enclosure

80A

WILLIAM H. LUNDQUIST
CERTIFIED PUBLIC ACCOUNTANT

1569 EDGE HILL ROAD - P. O. BOX 272
ABINGTON, PA. 19001
215 - 886-4195

May 27, 1987

Mr. John T. Crawford, Chairman
PICPA Auditing & Accounting Procedures Committee
Pa. Public Utility Commission
North Office Building
Harrisburg, PA 17120

Dear Jack:

Re: Exposure Draft: "Report of the National
Commission on Fraudulent Financial Reporting"

This Commission treats the question of external auditors' expansion of nonaudit services purely from the point of view of auditor independence, as did the Commission on Auditors' Responsibilities nine years ago.

In my opinion, expanding into client services that require non-accounting specialists (such as actuaries, industrial engineers, psychologists, or marketing people) poses a much greater danger to a proper audit environment within the audit firm than to its independence. Such specialists must be given recognition in the management of the audit firm. Even though they may not be designated partners, many of them must be classified as the equivalent of partners, and some of these will naturally gravitate to top management levels. The differences in training, experience and instilled ethical outlook will have their effect and change the firm environment in general and with respect to auditing in particular.

Auditing is, of course, a matter of techniques and procedures, but it is also a matter of attitudes and judgment. The effect of firm environment upon attitudes and judgment is apt to be significant.

Not treating the question of the effect on firm environment of "non-accounting" services of audit firms is a serious flaw of this exposure draft.

I would appreciate it if my letter were included in the Committee's response to the exposure draft, either by incorporating the gist of it in the response or by attaching a copy to the response.

Sincerely,

Bill Lundquist
Committee Member

81a

NORTHEAST UTILITIES



THE CONNECTICUT LIGHT AND POWER COMPANY
WESTERN MASSACHUSETTS ELECTRIC COMPANY
HOLYOKE WATER POWER COMPANY
NORTHEAST UTILITIES SERVICE COMPANY
NORTHEAST NUCLEAR ENERGY COMPANY

P.O. BOX 270
HARTFORD, CONNECTICUT 06141-0270
(203) 721-2313

GEORGE D. UHL
VICE PRESIDENT AND CONTROLLER

June 26, 1987

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

Northeast Utilities (NU or the Company), the parent company of the Northeast Utilities system, appreciates the opportunity to provide comments on the recommendations proposed by the National Commission on Fraudulent Financial Reporting (Commission). NU, through its operating subsidiaries, provides electric and gas service in Connecticut and electric service in western Massachusetts. NU has dealt with the issue of internal control and the cultivation of a proper control environment for a number of years now. The following is a brief synopsis of the internal control environment at NU and some specific comments and recommendations based upon our experience.

In 1979, NU created a Committee on Internal Control (NU Committee) which consists of several top management personnel and representatives of an outside law firm and an independent public accounting firm. The NU Committee was created to help address the requirements of the Foreign Corrupt Practices Act of 1977. The guidelines summarized in the AICPA's "Tentative Report of The Special Advisory Committee on Internal Accounting Control" (the Minahan Committee report) were adopted by the NU Committee. The NU Committee oversees several annual programs: Conflict of Interest Program, Internal Control Awareness Program, Computer System Control Reviews, and a follow-up on audit findings.

In addition to the programs outlined above, the NU Committee periodically reviews operational areas to assess the extent of their awareness and sensitivity to internal controls. The NU Committee efforts are fully supported by senior management and the Board of Trustees. Internal controls are discussed at periodic management staff meetings and are included in several in-house formal training programs, such as our training course for new supervisors and our internal control techniques course.

The work of the NU Committee enables it to publish an Annual Report to the Chairman, copies of which are provided to the Audit Committee of the Board of Trustees. This Annual Report is also the basis for inclusion in our

Annual Report to Shareholders of NU's "Company Report" which is an assessment of our internal control environment and cites the company's, as opposed to the independent auditor's responsibility for the financial statements.

The Company has also established an Audit Committee comprised solely of outside trustees. The position of Director-Internal Audit (DIA) reports administratively to the Senior Vice President-Finance and functionally to the Chairman/Chief Executive Officer. The DIA also has unrestricted access to NU's independent Audit Committee.

Through the efforts of our external advisors, we have been aware of the Commission's efforts, as well as legislative proposals, on financial reporting matters, such as the Wyden and Proxmire bills. The NU Committee supports most of the recommendations made by the Commission, and feels that management involvement, especially that of senior management, is the most critical element in preventing fraudulent financial reporting.

Based upon our experiences of the past eight years, NU offers the following comments and suggestions:

- o Included in the "tone at the top" there should be an internal educational program for all management personnel that relates the internal control environment to their areas of responsibility on a daily basis.
- o Under the Internal Audit function, it should be emphasized that few, if any, limitations should be placed on the work of the Internal Audit Department.
- o Under the mandatory independent Audit Committee, it was recommended that all public companies develop a written charter. Our concern, based upon the issues we dealt with during the formation of our independent Audit Committee, is that a written charter may be restrictive or proscriptive and, therefore, the Audit Committee may not investigate certain areas not specifically spelled out in the charter or continue to examine items that are no longer relevant. NU believes that it is more important to establish something similar to the "tone at the top." Therefore, we recommend that independent Audit Committees be given the same "carte blanche" recommended above for the Internal Audit Department.
- o Under the section entitled, "Reporting on Responsibilities in the Annual Report to Stockholders," it was recommended that the Chief Executive Officer and Chief Accounting Officer sign the Management Report. Our concern is that specifying these two signatures might imply that these are the only officers who have responsibility for the company's internal control environment. It would be more appropriate to indicate that this report is endorsed by the company. We agree with the views of the American Bar Association's ad hoc committee on reports by management, as expressed in their 1981 discussion paper, which

recommended that reports of this type be entitled "company report" rather than "management report" for the reasons stated in their discussion paper.

- o In the Quarterly Reporting section it was recommended that the Audit Committee approve financial results. NU recommends that the word "approved" not be used, but indicate that the Audit Committee has "reviewed and accepted" the financial statements as prepared by management.

In addition to these specific recommendations, the NU Committee also considered the recommendations for the public company in general and concluded that there were too many specific recommendations, especially as they pertain to the Audit Committee. Some NU Committee members felt that the time demands on the Audit Committee created by the specific recommendations could be onerous and, therefore, may limit the potential candidates available to public companies. We would like to reemphasize our position that the most important element in preventing fraudulent financial reporting is the environment established by senior management. It might be more appropriate to require companies to establish and maintain a sound internal control environment, ensure that internal control objectives are properly documented, transmit that message to all members of the management team, and require that the accounting/internal audit functions assess the operation of the internal control environment on a periodic basis. NU concurs with the requirement to include that assessment in the Annual Report to Shareholders. In addition, we concur with the idea that each public company should have an Audit Committee comprised solely of independent directors or trustees.

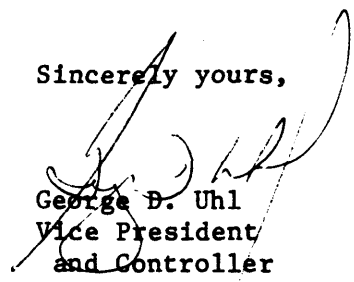
The independent Audit Committee should be required to review periodically the company's financial results and at a minimum, conduct, on an annual basis, an overview of the internal control environment. The independent Audit Committee should be able to meet with the company's management personnel, internal auditors, and the independent public accountants collectively and individually to enable them to assess the internal control environment. However, how this should be carried out should be left to the discretion of each company as it is impossible to develop a "laundry list" of specific recommendations that may or may not be applicable in all cases. We suggest that there be certain minimum standards, and that companies be required to assess whether those minimum standards are adequate to their operations.

We have not commented specifically on the other areas as they are not within our area of expertise. However, we do concur with many of the items listed, especially the recommendations for improvement in the area of education.

The NU Committee feels it is in a unique position to comment on this report because of the actions we have taken since 1979 to assure a proper internal control environment at NU. NU has endeavored to establish an internal control environment which encourages the maintenance of high standards of conduct in all of its business activities. The Commission

Report is an endorsement of those activities, and our recommendations and/or suggestions are intended to provide you with some practical applications in developing and administering an appropriate internal control environment.

Sincerely yours,



George D. Uhl
Vice President
and Controller

GDU/jem/t



DAYTON HUDSON CORPORATION

777 Nicollet Mall
Minneapolis, Minnesota 55402
612/370-6948

June 26, 1987

Commissioners
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Ave., N. W.
Washington, D.C. 20006

Dear Sirs:

Dayton Hudson Corporation, a diversified national retailer and a strong supporter of good Corporate governance, is pleased to respond to the Commission's request for comments on its Exposure Draft Report of the National Commission on Fraudulent Financial Reporting.

We strongly support the Commission's objective of reducing the risk of fraudulent financial reporting. Dayton Hudson has traditionally emphasized the importance of strong and effective controls. Our management already has implemented most of the recommendations in the Report. We believe good controls and policies are necessary to ensure the integrity of our financial statements, in support of our fiduciary role to our shareholders.

We are particularly supportive of the Commission's view of the need for a cost-benefit approach. As the Commission finalizes its recommendations, we urge you to continue to retain this practical approach for developing controls to minimize fraudulent financial reporting while emphasizing cost-effectiveness.

We appreciate the opportunity to provide our comments on this important issue.

Sincerely,

Susan S. Boren

Susan S. Boren
Vice President, Control

SSB:t1s

C4.3: 0615SSB



RUBBERMAID INCORPORATED . WOOSTER, OHIO 44691-0800 U.S.A.
1147 AKRON ROAD TEL. 216/264-6464 TELEX 986-491

June 26, 1987

Mr. James C. Treadway, Jr.
Chairman
National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

RE Comments on the Exposure Draft of the National Commission on
Fraudulent Financial Reporting

Dear Mr. Treadway

This letter is Rubbermaid's response to the request for comments on the Commission's recommendations for reducing the risk of fraudulent financial reporting by a public company.

We feel that the Commission has done a commendable job in emphasizing the importance of the financial reporting system and the attention that needs to be placed upon safeguarding its integrity. However, the benefits expected to be derived from the recommendations need to be weighed against the additional costs which affect the competitiveness of U. S. companies. In addition, the effectiveness of some of the suggestions needs to be evaluated.

For the most part the recommendations of the Committee are a summary of the philosophy and procedures regarding financial reporting that are presently followed by most public companies including Rubbermaid. There are, however, several recommendations which we encourage the Commission to reconsider as follows:

We agree with the recommendation that "The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors." However, the sentence following this recommendation states that

"An audit committee consisting of independent directors is the primary vehicle a board of directors uses to discharge its responsibility with respect to the company's financial reporting." We believe that this is an unreasonable expectation of the function of audit committees. First of all, very few audit committees meet more than three or four times a year and only for a limited length of time. They must, therefore, rely to a great extent upon information furnished by management and outside auditors. Also, the members cannot devote substantial time to the investigation that such a burden would require. To imply that the audit committee represents the primary vehicle in insuring the integrity of a company's financial reporting would expose the committee to an unfair burden and may result in their being subject to litigation. We also believe that the Commission's recommendations and guidelines would intensify difficulties in recruiting qualified directors because of concerns over increased director's liability. I believe the directors' primary vehicle is strict accountability for the management in proper preparation of financial data, as monitored by the directors' oversight by internal auditors and public accountants.

Recommendation -- "All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the Chief Executive Officer and Chief Accounting Officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls." This requirement is redundant because management clearly has these responsibilities already, and a statement saying we have them is just a use of more space in the annual report. I believe the SEC has an obligation to recognize the cost impact of lengthening the report.

Recommendation -- "All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the Chairman of Audit Committee describing the Committee's responsibilities and activities during the year." We believe as stated in the previous comment that such a requirement would increase the length of the annual report without adding to the comprehension of the financial results. The added verbiage would increase the cost of the report and be unnecessary since the disclosure would likely be similar between companies. Much of the information is currently required to be included in the proxy statement.

Recommendation -- "When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or

- 3 -

auditing issues discussed with its old or new auditors during the three year period preceding the change." Companies frequently discuss accounting issues with their public accountants and publication of these can be confusing and misleading. I believe the present SEC rule covers this adequately, and the concept should only be applied when a material dispute leads to a change in public accountants. This recommendation also tends to lock a company in with an accountant, whereas I believe the accountants should be subject to the normal marketplace obligations to provide effective service at a competitive fee.

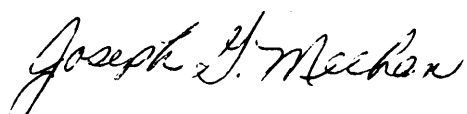
Recommendation -- "Audit Committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release." Having the Audit Committee review and approve the financial results prior to public release would slow down the release process which would increase the possibility of the improper use of the information prior to its being made public and would deprive the public and investors of timely access to the data. Rubbermaid's quarterly information is currently reviewed by our management and by our public accounting firm prior to the release, and we believe this is sufficient to insure its objectivity and accuracy. This recommendation implies that the members of the audit committee are accountants, or have available to them accounting expertise in addition to management accountants and the firm's public accountant.

Recommendation -- "The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control." We do not believe that it would be of significant assistance to the readers of a financial report for the auditor to describe the extent to which they have reviewed and evaluated the system of internal accounting control. Here again, there would be a costly addition to every company's annual report. Also, the requirement to state that the audit does not provide absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error seems unnecessary for all but the most naive readers of financial reports. These statements might be issued by each public accounting firm, but they do not belong in every report.

In summary, we believe that the financial reporting and control procedures and safeguards currently practiced by companies which are necessitated by good business requirements, together with the current governmental regulations and existing efforts of the public accountants, are sufficient to insure a reasonable level of accuracy and financial reporting for public manufacturing

companies. Additional regulations would add substantially to costs and not significantly increase the reliability of financial reporting.

Very truly yours



Joseph G. Meehan
Senior Vice President &
Chief Financial Officer

np

AUDITING STANDARDS COMMITTEE
MARYLAND ASSOCIATION OF CERTIFIED PUBLIC ACCOUNTANTS
1300 YORK ROAD, SUITE 10
P. O. BOX 484
LUTHERVILLE, MARYLANND 21093

NATIONAL COMMISSION ON
FRAUDULANT FINANCIAL REPORTING
1701 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20006

JUNE 26, 1987

THE MACPA'S AUDITING STANDARDS COMMITTEE HAS REVIEWED THE COMMISSION'S EXPOSURE DRAFT. WE COMMEND THE COMMISSION ON THEIR EFFORTS TO ADDRESS AND DEAL WITH MEASURES WHICH ARE DESIGNED TO PREVENT OR DETECT FRAUDULENT FINANCIAL REPORTING. GENERALLY, WE REACHED AGREEMENT WITH, OR DID NOT STRONGLY DISAGREE WITH, ALL OF THE COMMISSION'S RECOMMENDATIONS, EXCEPT ONE.

WE WERE NOT CONVINCED THAT IT WAS EITHER NECESSARY OR APPROPRIATE FOR THE MEMBERSHIP OF THE AICPA'S AUDITING STANDARDS BOARD TO BE OPENED TO NON-CPA'S. WE BELEIVE THAT THE ASB CAN CONTINUE TO BE EFFECTIVE WITHOUT HAVING NON-CPA'S AS MEMBERS.

SOME OF OUR MEMBERS WERE CONCERNED THAT THE 60 DAY COMMENT PERIOD MAY BE TOO SHORT A TIME FOR THE PUBLIC TO STUDY AND RESPOND TO THE EXPOSURE DRAFT.

VERY TRULY YOURS,



DAVID A. COVINGTON
CHAIRMAN,
MACPA'S AUDITING STANDARDS COMMITTEE

San Diego Gas & Electric

FRANK H. AULT
CONTROLLER

June 29, 1987

FILE NO.

National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue N.W.
Washington, D.C. 20006

Commissioners:

The purpose of this letter is to provide our response to your recent Exposure Draft. SDG&E already practices many of the recommended actions such as having internal controls, an audit committee and internal auditors. Some of the recommendations are apple pie, such as maintaining accounting functions that are effective, internal audit functions that are objective and audit committees that are informed, vigilant and effective overseers. Accordingly, we agree with most of the recommendations.

There are two recommendations that we strongly disagree with. One is:

"When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change."

We discuss many sensitive accounting and auditing issues, including contingencies, with our auditors. These discussions have always ended in consensus. Important events and accounting treatments related to such issues are disclosed in the financial statements. Current SEC rules require disclosure of any disputes over accounting or auditing issues if a company changes auditors. We believe the additional disclosure proposed by the commission would be unnecessary and sometimes even detrimental to shareholder interests. The three-year rule would discourage companies from changing auditors even when they legitimately are dissatisfied with their auditor's performance. This rule would serve the financial interests of CPA firms more than it would the shareholders.

The other recommendation we strongly disagree with is:

"All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year."

85a

San Diego Gas & Electric

National Commission on
Fraudulent Financial Reporting

-2-

June 29, 1987

In addition, you recommend a separate letter from the Controller. Our annual report already includes a letter from the Controller briefly covering the audit committee. That letter, plus the one you recommend, plus the auditors' opinion, makes three letters covering what is, for the most part, the same subject. We believe that is unnecessary. Surveys of the investing public have clearly indicated a need for less boilerplate in the annual report. They have also clearly indicated that the investor does not read such material.

For the past ten years, Congress (currently the Dingell Committee) and the SEC have shown particular interest in reducing fraudulent financial reporting. Their attention has largely focused on the failures of CPA firms to detect material fraud or deficiencies in financial reporting. We share their belief that the purpose of an audit is to detect material errors or deficiencies in the financial statements, whether caused by fraud or other reasons. We also believe, however, that a company should not rely wholly on its auditors.

We believe your exposure draft adequately covers what a company can do to prevent fraud. We are not confident, however, that your recommendations adequately address poor audit quality. One of your recommendations is:

"Public accounting firms should recognize and control the organization and individual pressures that potentially reduce audit quality."

You have recognized the problem, but you have not made a concrete recommendation. Are you going to leave that to Congress?

Sincerely,



Frank H. Ault

FHA/KCG:pap

June 29, 1987

The National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue NW
Washington, D.C. 20006

RE: Exposure Draft dated April 1987

The recommendations by the Commission on Fraudulent Financial Reporting includes many recommendations which are very beneficial for the understanding of the responsibilities related to the financial reporting by all members of the business community as well as the public. The following addresses each of the major topics of the recommendations for the public reporting process. It appears in reviewing this report, a great deal of effort and time has been expended in developing these recommendations.

RECOMMENDATIONS FOR THE PUBLIC COMPANY:

The Tone at the Top: These recommendations should be developed in companies who do not already have this understanding. It is our impression most public companies have individuals in the executive management area who are familiar with obligations of financial reporting and there is a code of corporate conduct. The development of a code of conduct in written form will serve to communicate more clearly the understanding of the intentions of the company regarding reporting matters.

The Requirement of Auditing Committee: To review compliance of the code annually should fall within the responsibility of the internal audit function.

The Accounting Function and Chief Accounting Officer: The public company must maintain accounting functions that effectively meet their financial reporting obligations.

Internal Audit Function and Chief Accounting Auditor: The recommendation for public companies to maintain an effective internal audit function staffed with an adequate number of qualified persons for a company of that size is fair and reasonable for large public corporations. The commission should review the feasibility of small public companies with characteristics such as limited numbers of transactions, revenues, or total capital which make the internal audit function non cost effective. The general rule requiring an effective internal audit function should be deleted and replaced by a recommendation that the company should evaluate the need for such. If an internal audit staff is cost effective the internal audit function should be independent from the financial process.

FREEMAN PROPERTIES, INC.

2517 Lebanon Road • P.O. Box 140478 • Nashville, Tennessee 37214
(615) 889-8250 • Tennessee WATS 1-800-221-7487 • Nationwide WATS 1-800-221-3947

Dea

The National Commission on Fraudulent Financial Reporting
June 29, 1987
Page 2

Mandatory Independent Audit Committee: The requirements of an independent audit committee consisting solely of independent directors would put undue burden on small public entities as the cost in the future for retention of independent directors will escalate with the increased responsibilities. Additionally, the recommendation that a report be issued by the audit committee to be included in the financial statements increases the exposure of directors once again increasing fees. The result to a small company will be to place undue burden on its financial results. In looking at the independent audit committee, the commission needs to evaluate a minimum requirement of capital or revenues for this obligation. It would be very difficult for small organizations to feasibly have independent directors who are informed and effective overseers to the financial reporting process without sufficient fees which could be detrimental to operations of a company.

Reporting on Responsibilities in the Annual Report to Stockholders: With the proposed change by the Auditing Standards Board in the audit opinion letter releasing more responsibility from the independent accountant, the recommendation for a letter from the Chief Executive Officer and the Chief Accounting Officer seems to be unnecessary in reporting. The public accounting profession has taken measures here to disassociate itself from responsibility for financial reporting and have stated so in the proposed new opinion letter. The proposed opinion letter describes the responsibility of the accountants. With the changes in the standard audit report, the responsibility of each party is clarified.

The requirement for the annual report to stockholders to contain a letter signed by the Chairman of the Audit Committee only increases economic burden on a small company to comply with the regulation. This recommendation should be removed from the report.

Seeking a Second Opinion: When a second opinion is sought, the Audit Committee should be made aware. The recommendation to publicly disclose the nature of any material accounting or auditing issue is already handled through Item 304 of the S-K requirements whereby disagreements and changes in accountants are noted. The recommendation seems to be duplicating the public reporting requirement.

Quarterly Reporting: With the utilization of independent directors working as the auditing committee, small businesses again run the risk of financial burden as well as timing problems by having the directors involved in the quarterly reporting process. The independent director requirement causes increased charges from travel and increased directors fees. The concern is one which potentially delays the quarterly reporting process while definitely increasing the cost with very little benefit.

Setting Standards for Internal Control: The recommendation for the commission to sponsor organizations in establishing a body to guide public companies on internal control is positive. During this process, internal controls must be considered that do not overburden small companies in developing the controls. The sponsor organization should develop what are reasonable controls as it relates to industry and allow flexibility to prevent strenuous detail being required.

RECOMMENDATIONS FOR INDEPENDENT PUBLIC ACCOUNTANT:

Recognizing Responsibilities for Detecting Fraudulent Financial Reporting and Improving Detection Capabilities: The establishment of the responsibility of the independent accountant to uncover fraud will continue to put the public company and accounting firms in adversarial positions to an even greater extent. Consideration must be given to avoid this conflict. Most of the recommendations made in these sections should be required though any reputable firm should be performing the analytical review procedures. The requirement for independent public accountants review of quarterly financial data of the public company can create problems for the small company on the timing and costs associated with such review. The review currently required at year end on the smaller company should be sufficient.

Improving Audit Quality: All recommendations under improving audit quality should be adopted by the SEC as these continue to improve the quality and performance of the audit review.

Communicating the Auditors Role: The proposal of the Auditing Standards Board to revise the auditors report should be completed. This clarifies to the public the responsibility the accountants are taking and indicates responsibility of management. This report should make the public more aware of the assurance provided by accountants.

Doc

The National Commission on Fraudulent Financial Reporting
June 29, 1987
Page 4

Reorganization of the Auditing Standards Board: The reorganization of the Board should be completed so that users of the financial data have opportunity for input.


RECOMMENDATIONS FOR EDUCATION:

Business and Accounting Curriculum: The recommendations for this area should be adopted as it provides the basis for what accounting schools and business schools should be providing to potential accountants and business persons which we are developing for the future.

Professional Certification Examinations and Continued Professional Educations: It is not necessary to extend the certification requirements or continued professional education as the profession has made adequate advances. The requirements of the AICPA are sufficient.

The recommendations by the National Commission of Fraudulent Financial Reporting should be adopted for use by the SEC with modifications as mentioned in the comments. Hopefully, this response will be helpful to the commission in defining the needs.

Sincerely,



Jerry T. Walker

JTW/pl

Southwestern Bell Corporation

Edward E. Whitacre, Jr.
Vice Chairman and
Chief Financial Officer

One Bell Center
St. Louis, Missouri 63101
Phone (314) 235-2524

June 29, 1987

Mr. G. Dewey Arnold
Executive Director
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, Suite 300
Washington, D. C. 20006

Dear Mr. Arnold:

We appreciate the opportunity to provide comments on the recommendations in the April 1987 Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting.

We are generally in agreement with the recommendations included in the report and support the Commission's efforts to identify the causes of fraudulent financial reporting and identify steps to reduce its incidence. Our comments will cover those areas which we feel warrant further consideration or in which we have a particularly high level of support and interest.

We encourage further consideration of the following recommendations which we feel are unnecessary or impractical:

- We believe it is impractical for audit committees to approve financial results prior to public release. The timely review of financial results with the Audit Committee, discussion of significant changes in accounting or financial reporting practices, and approval of Form 10-Q before filing with the SEC should constitute adequate oversight measures.
- We believe that advance approval of independent public accountants' management advisory services would be impractical and would inappropriately place the Audit Committee in an operating role. However, we feel that the Committee's oversight role should include a review of the management advisory services by the independent public accountants in order that it may determine whether the extent of such services impairs objectivity.

- We generally satisfy the requirement for independent public accountant's review of quarterly financial data in that a high level review is performed prior to each quarterly earnings press release and a complete review is completed before final release of 10Qs to the SEC. However, in our view, such a requirement for smaller firms would be onerous and extremely costly. Furthermore, if this recommendation is meant to require more extensive testing prior to quarterly press releases, we have a real concern in that such additional review would delay the release of earnings data and increase the risk of financial information being leaked on a selective basis.
- We believe independent public accountants should design audits to detect material errors in financial statements. While the risk of fraudulent financial reporting should be considered in developing audit plans, we feel it would be inappropriate to rely upon the audit for assurance of fraud detection. To do so would tend to detract from management's responsibility for fraud prevention and detection, would increase the audit fees and would not significantly affect the end result.

We strongly agree and support the Commission's view that the SEC should reconsider its long-standing position against corporate indemnification. The perceived directors' and officers' insurance liability crisis could have a negative impact on financial reporting. In order to ensure qualified directors are available, indemnification should be allowed and the SEC should reconsider its position.

We are impressed with the comprehensiveness of the Commission's study and feel that your recommendations form a balanced response to fraudulent financial reporting. Our company is giving further consideration to implementation of those few recommendations in which we presently do not fully comply.

Sincerely,



Vice Chairman and
Chief Financial Officer



ROBERT P. SCHAEN
Vice President
and Comptroller

30 South Wacker Drive
Chicago, Illinois 60606
312/750-5250

June 29, 1987

Mr. James C. Treadway, Jr.
Chairman
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Dear Mr. Treadway and Fellow Commissioners:

The Report of the National Commission on Fraudulent Financial Reporting (Commission) is an excellent treatise on fraudulent financial reporting and American Information Technologies Corporation (Ameritech) supports the overall goal of the Commission. Most of the recommendations concerning public companies are being practiced at Ameritech today, therefore our comments will be brief and to the point. In addition to commenting on the public company recommendations, we also comment on the independent public accountant recommendations where they directly affect their business relationship with us.

AMERITECH'S REPLY COMMENTS

Tone at the Top

We are in basic agreement with the recommendations in this area. We believe the heading "Tone at the Top" captures the essence of what top management can do to prevent fraudulent financial reporting. However, in a large complex organization, top management must be able to rely on personnel with the professional skills to identify and assess factors that contribute to fraudulent reporting. Top management's obligation is to require that risk analyses be performed, evaluate the results, formulate policy and endorse appropriate changes. We suggest that your final recommendation focus more on management's initiation of appropriate actions and recognize the fact that top management's ability to place reliance on skilled professional employees is integral to running a well controlled company.

The recommendation concerning the establishment of "...internal controls that are adequate to prevent and detect fraudulent financial reporting..." implies that management has the ability to reduce the potential for such reporting to a zero probability level. It has long been recognized in accounting and financial literature that there is a trade-off between the cost and associated benefits of implementing internal controls. In order to balance the interests of stockholders, creditors and customers, management necessarily evaluates cost/benefit trade-offs implicit in control systems. No system of internal control can be so effective that it eliminates the possibility of fraudulent reporting and still remain affordable to customers and investors. We suggest that your final recommendation reflect this trade-off and indicate that it is more reasonable to seek systems that reduce the potential for fraudulent reporting to a low probability level.

Accounting and Internal Audit

We agree with the recommendations in this area.

Audit Committee of the Board of Directors

We share the Commission's view that audit committees play a significant role in the financial reporting process. Their role is oversight in nature and they must be able to rely on management and outside professionals. Oversight is exercised by being knowledgeable of the company's business, asking appropriate questions and pursuing relevant issues. All of these things are largely accomplished through open and effective communications with management and outside professionals, such as the independent public auditor. Although the audit committee should be vigilant, they also have a right to place reliance on management and others to provide appropriate and accurate information. The audit committee also has a right to rely on the advice and counsel of experts. They can place reliance on others and still fulfill their integral role in the financial reporting process.

Although the Commission's recommendations emphasize the responsibilities of audit committees, they do not adequately recognize the nature of audit committees and the inherent limitations imposed on their role as overseers of the financial reporting process. We suggest that the recommendations in this area be placed in the context within which audit committees actually function — they provide oversight and must place substantial reliance on management and external experts. By not providing the appropriate balance between the responsibilities of audit committees and the means by which they meet their responsibilities, the essence by which audit committees operate is missed and could potentially expose audit committee members to more liability than is justified.

We agree that the audit committee should have a written charter and it should be approved by the Board of Directors. However, we feel that an annual review of the charter is unnecessary and will become a perfunctory process. We believe the charter should be written in broad terms that identify the committee's major responsibilities. The charter should only be reviewed as the need arises, such as a significant change in the company's business environment (e.g., the company enters foreign markets for the first time).

We believe that the audit committee should have all the resources necessary for them to adequately fulfill their responsibilities. We believe these resources should come from the existing staff within the company and be used by the audit committee as the need arises.

We are in substantial agreement that management advisory services (MAS) should be reviewed and approved by the audit committee. However, no evidence exists to indicate that MAS detracts from the auditor's independence. Moreover, the audit committee already has the responsibility of evaluating situations which bear upon the auditor's independence. All MAS should be approved by the audit

committee either before the service is rendered, or after. For practical reasons, a range of services which are of a routine operating nature may be pre-approved by the audit committee and reviewed in more detail with the committee after the fact. Those services which are more sensitive in nature, and which, in the audit committee's judgment may be perceived as influencing the auditor's independence, e.g., executive search services, actuarial services, etc., should be approved on a case by case basis by the Audit Committee in advance.

Reporting to the Public on Management and Audit Committee Responsibilities

We agree with the improvements you recommend for communicating management's responsibilities to the public. However, inclusion of a report from the audit committee chairman would result in predominantly redundant information and would become a perfunctory letter that no one will read. The report indicated that "...the audit committee members' awareness and acceptance of the importance of their responsibilities..." would be reinforced by such a letter. With the attention given by the media to shareholder suits and large settlements, the reality is that audit committee members, and board directors in general, are very much aware of their responsibilities. The fact that some companies are having difficulty obtaining qualified directors is clear evidence that awareness of the responsibilities at the board and audit committee levels is simply not an issue.

Additional Recommendations

We agree that the audit committee has a responsibility for the quarterly reporting process, just as it does for the annual reporting process. Whether a specific audit committee needs to improve their oversight of quarterly reporting depends on the individual facts and circumstances. In any event, we do not believe that the audit committees will significantly deter fraudulent financial reporting by approving quarterly financial results prior to public release. The quarterly financial reporting process is but one element of the entire system of internal control. The entire system is subject to the audit committee's oversight. In exercising its oversight responsibilities, the audit committee has a right to rely on management and the company's auditors (internal and independent). The internal and independent auditors have free and full access to the audit committee and its individual members. Independent auditors should be required to review quarterly data prior to public release (and they do at Ameritech). The independent and internal auditors are obligated to inform the audit committee on a timely basis of material control deficiencies, including deficiencies associated with quarterly financial reporting. These relationships and processes provide the basis for preventing and detecting fraudulent financial reporting. By ensuring that these processes and lines of communication are in place, the audit committee has fulfilled its oversight responsibilities. Adding additional meetings would not be meaningful.

88c

Setting Standards for Internal Control

We believe that establishing an additional body to guide public companies on internal control concepts would not be productive. The report mentions that there have been varying interpretations and philosophies concerning internal control and sometimes disagreements occur between independent accountants, management and internal auditors over internal control issues. The report implies that the source of the disagreements result from the fact that many organizations study this issue. We do not believe that there has been sufficient work performed in this area to identify a cause and effect relationship. We believe that there can be disagreements in this area because it is a complex subject and not easily adaptable to precise or quantitative measurements. Including one more organization to study the matter will not improve the situation in light of the fact that the proposed new organization will be no more authoritative than the other organizations. Debates will continue and in most instances the debates are healthy in attempting to measure the costs and benefits associated with internal controls.

Other

With regard to those recommendations within the public company section for which we have not provided a specific reply, we are in basic agreement with the Commission's recommendations.

Independent Public Accountants

With regard to the Commission's recommendations concerning independent public accountants, there are three that we feel it is appropriate for us to comment. The three relate to:

- . Establishing standards requiring independent accountants perform analytical review procedures;
- . The requirement that independent accountants review quarterly financial data prior to public release; and,
- . The requirements concerning concurring or second partner reviews.

These three areas deal directly with the independent accountant's engagement performance. In our view, all three add to the quality of services rendered by the public accountant and we agree with them.

- - - - -

We appreciate the opportunity to provide input and we hope you will consider our views as you develop the final report.

Sincerely,



89

NATIONAL ASSOCIATION OF ACCOUNTANTS
10 PARAGON DRIVE
MONTVALE, NEW JERSEY 07645-1760
(201) 573-9000

MANAGEMENT ACCOUNTING
PRACTICES COMMITTEE

June 29, 1987

1986-87 MEMBERS

William J. Ihanfeldt, *Chairman*
Shell Oil Company
Houston, Texas

Raymond H. Alleman
ITT Corporation
New York, New York

Robert N. Anthony
Harvard Business School
Boston, Massachusetts

James P. Colford
IBM Corporation
Tarrytown, New York

Patricia P. Douglas
University of Montana
Missoula, Montana

Bernard R. Doyle
General Electric Company
Fairfield, Connecticut

Eugene H. Irmingier
Centel Corporation
Chicago, Illinois

James J. Latchford
W.R. Grace & Company
New York, New York

Arthur D. Lyons
FMC Corporation
Chicago, Illinois

Frank C. Minter
AT&T International
Basking Ridge, New Jersey

John J. Perrell, III
American Express Company
New York, New York

J. Charles Stracuzzi
Blount Agriproducts Group
Grand Island, Nebraska

Norman N. Strauss
Ernst & Whinney
New York, New York

Edward W. Trott
Peat, Marwick, Mitchell & Co.
Tampa, Florida

Robert G. Weiss
Schering-Plough Corporation
Madison, New Jersey

Staff -
Management Accounting Practices

Louis Bisgay, Director

Jonathan B. Schiff, Manager

The National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

The Management Accounting Practices (MAP) Committee of the National Association of Accountants appreciates the opportunity to express our points of view on the REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING. We applaud the Commission on its exhaustive research and documentation, and believe that the overall effort is a major achievement exemplary for present and forthcoming private sector initiatives to minimize the incidence of fraudulent financial reporting. It is unfortunate that such an effort has been perceived necessary, as the problems caused by only a few have created concerns for many. We note that most companies are honest and that many have long adhered to most of the report's guidelines. Furthermore, we are concerned that your effort and the efforts of others are tending to be overreactive and potentially leading to cost inefficient practices. Nevertheless, we would encourage members of the business community to assimilate the final report and to comply, in varying degree depending upon each member's size and financial ability, with its spirit. In fact, the NAA will help disseminate and publicize the final report. Moreover, we trust that this process will preclude any perceived need for legislative action as a cure for the problems identified in the report.

Our comments regarding certain specific recommendations follow. We have numbered each recommendation for ease of reference (see the attachment).

89a

RECOMMENDATIONS FOR THE PUBLIC COMPANY

The Tone at the Top and Accounting Function and Chief Accounting Officer

We fully agree with the degree of importance that the Commission has placed on the tone set by top management and the need for an effective accounting function. To further enhance the discussion of ethics, the Commission should consider including in the appendices the codes of ethics of the sponsoring organizations.

Recommendation 2: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

It is virtually impossible to prevent fraud, especially if it includes collusion, once perpetrators set their minds to it. We recommend that the Commission substitute "to reasonably assure the prevention and detection of" for "to prevent and detect."

Internal Audit Function and Chief Internal Auditor

Recommendation 5: Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.

Our only concern with this recommendation is that it may be construed to require the very small public business to hire someone for an internal audit function vis-a-vis assigning the function to an existing employee. Therefore, we recommend that "and practical" be inserted after "appropriate."

Recommendation 6: Public companies should ensure that their internal audit functions are objective.

We generally agree with this recommendation, but we suggest expanding the discussion on organizational structure. In its description of the recommendation, the Commission strongly encourages a reporting relationship whereby the chief internal auditor reports directly to the CEO. Furthermore, the organization chart on page 15 for "The Public Company" indicates that the internal audit function reports directly to the CEO. We disagree with the emphasis placed on this organizational structure and feel that it should not be worded so restrictively.

Since the CFO takes an active role in the prevention of fraud (and "...should be held responsible for fraudulent financial reporting," according to page 32), he should also take an active part in the scope of the internal audit function. Hence, it is often more appropriate for the chief internal auditor to report to the CFO. Therefore, the report should deemphasize the reporting relationship with the CEO and recognize more explicitly that the appropriate reporting relationship depends on what is practical for the particular company. More emphasis, however, should be placed on the chief internal auditor's full and free access to the audit committee and CEO (and they to him).

In addition, we disagree with the discussion insofar as it requires a trained professional auditor in the chief auditor's position. For some companies this is impractical, for others undesirable. The discussion should instead state that the position be staffed by a person qualified to manage the function, as deemed appropriate by both management and the audit committee.

Mandatory Independent Audit Committee

In addition to our comments below, we do have a general concern with the overall recommended role of the audit committee. We are concerned with the Commission's objective to make the audit committee deeply involved in the financial reporting process. It is possible that the Commission's recommendations will cause the audit committee to become so embroiled in the financial reporting process that it will lose sight of its oversight role and become a mirror image of management, hence losing the independent control aspects the Commission is trying to achieve.

Recommendation 9: The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.

We support the concept of this recommendation, but we are concerned that it may be difficult to implement for small companies that are not covered by current NYSE rules. Rather than recommending an SEC mandate, we propose that the Commission recommend that the private sector take the initiative in voluntarily implementing this recommendation and that the question be reexamined by the SEC after a period of time.

Recommendation 14: The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

We agree with the intent of this recommendation, but we take exception to the proposed implementation. Prior approval would involve the audit committee in operational concerns. The audit committee should be made aware of these services in order to judge the independence of the public accountant (as cited in the previous recommendation) and to ensure that controls are in place, and should be kept informed as to the progress and completion of such projects. However, prior approval and review is impractical and unnecessary.

Reporting on Responsibilities in the Annual Report to Stockholders

Recommendation 16: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

The financial sections of many annual reports already include a report from management and a report from the independent public accountant. The requirement of a letter from the chairman of the audit committee would clearly constitute a case of information overload. The value of an audit committee lies in its oversight responsibility, not in its publicity. The reporting relationship the audit committee has with the board of directors carries with it an implication that the committee is fulfilling its responsibilities. A listing of the committee's members, a description of its duties, and the frequency of their meetings should be more than sufficient.

Seeking a Second Opinion

Recommendation 17: Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.

Does the Commission have in mind both informal and formal second opinions? We believe it should be made clear that this Report is not addressing the many and varied types of informal discussions that do take place between representatives of companies and other audit firms; e.g. at professional meetings, at conferences, etc.

Recommendation 18: When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

In general, we feel that this recommendation is burdensome and does not improve the existing financial reporting system. The Commission's recommendation implies that the underlying motivation of changing auditors is merely to improve the financial results. There are many valid reasons why a company might seek to change its auditors. Changes in auditors are management's prerogative.

During the normal course of a year, as well as a year-end audit, there are numerous client/auditor discussions on various material issues from which agreements and disagreements result. To disclose these discussions would be unduly burdensome, and could violate a company's proprietary interests, even where the issue in question did not come to fruition. We believe current SEC Form 8-K requirements to disclose changes in and disagreements with auditors are adequate to keep the public informed.

Quarterly Reporting

Recommendation 19: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We agree with the general intent of this recommendation, but we believe individual audit committees should determine their involvement in the quarterly reporting process. An effective audit committee is continually involved in the assessment of the company's internal controls. This work would be the basis for their judgment as to the need to review and approve financial results prior to public release. In addition, the audit committee's pre-clearance of financial results would create many practical difficulties and would delay the timeliness of the release, thereby inhibiting the flow of information to the public. This recommendation should be optional rather than mandatory.

RECOMMENDATIONS FOR THE INDEPENDENT PUBLIC ACCOUNTANT

Overall, the recommendations in this chapter are very good. We support the concepts proposed by the Commission and commend the AICPA and the Auditing Standards Board for their initiatives in addressing these issues. We generally support each of the specific issues, but we have cost/benefit concerns throughout the section. The following comments are limited since these issues are presently being addressed in the AICPA's due process proceedings.

89e

Improving Detection Capabilities

Recommendation 23: The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.

We agree with the intent of the Commission in this recommendation, but we feel there may be significant cost justification problems with it. We agree that quarterly reports play an important role in the financial reporting process, but it is unclear as to whether or not the review of quarterly financial data prior to public release will help to detect fraud. We acknowledge that there is a benefit to a limited review, but we feel that the incremental benefit may be offset by the additional cost incurred, timing problems created, and the independent auditor's staffing difficulties.

Improving Audit Quality

Recommendation 25: The AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.

We are concerned with requiring the concurrent reviewer to be involved in the planning stage of the audit. If the concurrent reviewer is too involved in the audit, his objectivity would be compromised. We are also concerned with the cost justification of this requirement.

RECOMMENDATIONS FOR THE SEC AND OTHERS TO IMPROVE THE REGULATORY AND LEGAL ENVIRONMENT

Additional SEC Enforcement Remedies

We support the overall concepts discussed in this section. In general, we feel the recommendations are appropriate, but there may be a need to build in some constraints. We agree that the SEC must have strong enforcement remedies in order to strengthen deterrence, but we are concerned that there may be some potential for abuses. We recommend that the Commission, in recommending the expansion of SEC powers, acknowledge that full due process and defensive remedies are available.

Recommendation 31: The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.

The term unsound can describe many practices unrelated to generally accepted accounting principles. We suggest restating the recommendation as follows:

"The SEC should have the authority to issue a cease and desist order when a securities law violation, an otherwise fraudulent practice, or a departure from generally accepted accounting principles is found."

Financial Institution Regulatory Agencies

Recommendation 38: The financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant.

We disagree that the auditor should be expected to provide information directly to regulators. An integral part of an audit is the free flow of information between the auditor and the client. The Commission's recommendations would detract from the auditor's ability to obtain this information. On the other hand, we support regulators' providing information to auditors.

Enhanced Enforcement by State Boards of Accountancy

Recommendation 39: State boards of accountancy should implement positive enforcement programs that periodically would review the quality of services that the independent public accountants they license render.

We agree with the intent of this recommendation. We feel, however, that it is unduly optimistic. There is a lack of uniformity between state boards of accountancy. In addition, the state boards should not duplicate the activities of other organizations. This process is similar to a peer review, which is already being addressed by the SEC.

RECOMMENDATIONS FOR EDUCATION

We fully agree with the recommendations in this section. Education of present and future participants in the work force plays an integral role in the prevention, detection, and deterrence of fraudulent financial reporting. We commend the Commission on its recognition of the important role education plays. We encourage educators' participation in the implementation of these recommendations.

899

Appendix H - Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting

The Commission's report does not address or refer to legal counsel, either in-house or external. We encourage the Commission to include a reference that, in an objective capacity, general counsel can be an effective force in helping to deter fraudulent financial reporting.

Appendix M - Good Practice Guidelines for Audit Committee Chairman's Letter

We do not feel it is necessary to include this letter in the annual report. This requirement would create unnecessary excess information.

* * * * *

In conclusion, the MAP Committee would again like to commend the Commission on its accomplishment and reiterate its support for achieving the stated objectives. The MAP Committee would be pleased to further discuss its views on these issues.

Very truly yours,

William J. Ihlanfeldt

William J. Ihlanfeldt
Chairman
Management Accounting Practices Committee

BSG/bb/jo/MAP52/NCF.1 NCF.8

COMPLETE SET OF RECOMMENDATIONS

Chapter One: Overview of the Financial Reporting System and Fraudulent Financial Reporting

No recommendations

Chapter Two: Recommendations for the Public Company

The Tone at the Top

- 1 **Recommendation:** For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.
- 2 **Recommendation:** Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.
- 3 **Recommendation:** Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. A company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.

Accounting Function and Chief Accounting Officer

- 4 **Recommendation:** Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.

Internal Audit Function and Chief Internal Auditor

- 5 **Recommendation:** Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.
- 6 **Recommendation:** Public companies should ensure that their internal audit functions are objective.
- 7 **Recommendation:** Internal auditors should consider the implications of their nonfinancial audit findings for the company's financial statements.
- 8 **Recommendation:** Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.

Mandatory Independent Audit Committee

- 9 **Recommendation:** The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.
- 10 **Recommendation:** Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.

- 11 **Recommendation:** *All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it at least annually, and modify it as necessary.*
- 12 **Recommendation:** *Audit committees should have adequate resources and authority to discharge their responsibilities.*
- 13 **Recommendation:** *The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.*
- 14 **Recommendation:** *The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.*

Reporting on Responsibilities in the Annual Report to Stockholders

- 15 **Recommendation:** *All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.*
- 16 **Recommendation:** *All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.*

Seeking a Second Opinion

- 17 **Recommendation:** *Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.*
- 18 **Recommendation:** *When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.*

Quarterly Reporting

- 19 **Recommendation:** *Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.*

Setting Standards for Internal Control

- 20 **Recommendation:** *The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.*

Chapter Three: Recommendations for the Independent Public Accountant

Recognizing Responsibility for Detecting Fraudulent Financial Reporting

- 21 **Recommendation:** *The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.*

Improving Detection Capabilities

- 22 **Recommendation:** *The Auditing Standards Board should establish standards to require independent public accountants to perform analytical review procedures in all audit engagements and should provide improved guidance on the appropriate use of these procedures.*
- 23 **Recommendation:** *The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.*

Improving Audit Quality

- 24 **Recommendation:** *The AICPA's SEC Practice Section should strengthen its peer review program by increasing review of audit engagements involving public company clients new to a firm. For each office selected for peer review, the first audit of all such new clients should be reviewed.*
- 25 **Recommendation:** *The AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.*
- 26 **Recommendation:** *Public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality.*

Communicating the Auditor's Role

- 27 **Recommendation:** *The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.*
- 28 **Recommendation:** *The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.*

Reorganization of the Auditing Standards Board

- 29 **Recommendation:** *The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice.*

Chapter Four: Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment

Additional SEC Enforcement Remedies

- 30 **Recommendation:** *The SEC should have the authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding.*

31 **Recommendation:** *The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.*

32 **Recommendation:** *The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company.*

Increased Criminal Prosecution

33 **Recommendation:** *Criminal prosecution of fraudulent financial reporting cases should be made a higher priority. The SEC should conduct an affirmative program to promote increased criminal prosecution of fraudulent financial reporting cases by educating and assisting government officials with criminal prosecution powers.*

Improved Regulation of the Public Accounting Profession

34 **Recommendation:** *The SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SECPS of the AICPA's Division for CPA Firms.*

35 **Recommendation:** *The SEC should take enforcement action when a public accounting firm fails to remedy deficiencies cited in the public accounting profession's quality assurance program.*

SEC Resources

36 **Recommendation:** *The SEC must be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting.*

Financial Institution Regulatory Agencies

37 **Recommendation:** *The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board (including the Federal Savings and Loan Insurance Corporation) should adopt measures patterned on the Commission's recommendations directed to the SEC to carry out their own regulatory responsibility relating to financial reporting under the federal securities laws.*

38 **Recommendation:** *The financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant.*

Enhanced Enforcement by State Boards of Accountancy

39 **Recommendation:** *State boards of accountancy should implement positive enforcement programs that periodically would review the quality of services that the independent public accountants they license render.*

Considering the Implications of Liability on Audit Quality

40 **Recommendation:** *Parties charged with responding to various tort reform initiatives should consider the implications that the perceived liability crisis holds for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting.*

Reconsidering Corporate Indemnification

41 **Recommendation:** *The SEC should reconsider its long-standing position that the corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable.*

Chapter Five: Recommendations for Education

Business and Accounting Curricula

- 42 **Recommendation:** *Throughout the business and accounting curricula, educators should foster knowledge and understanding of the factors that may cause fraudulent financial reporting and the strategies that can lead to a reduction in its incidence.*
- 43 **Recommendation:** *The business and accounting curricula should promote a better understanding of the function and the importance of internal controls, including the control environment, in preventing, detecting, and deterring fraudulent financial reporting.*
- 44 **Recommendation:** *Business and accounting students should be well-informed about the regulation and enforcement activities by which government and private bodies safeguard the financial reporting system and thereby protect the public interest.*
- 45 **Recommendation:** *The business and accounting curricula should help students develop stronger analytical, problem solving, and judgment skills to help prevent, detect, and deter fraudulent financial reporting when they become participants in the financial reporting process.*
- 46 **Recommendation:** *The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting.*
- 47 **Recommendation:** *Business schools should encourage business and accounting faculty to develop their own personal competence as well as classroom materials for conveying information, skills, and ethical values that can help prevent, detect, and deter fraudulent financial reporting.*

Professional Certification Examinations

- 48 **Recommendation:** *Professional certification examinations should test students on the information, skills, and ethical values that further the understanding of fraudulent financial reporting and that promote its reduction.*

Continuing Professional Education

- 49 **Recommendation:** *As part of their continuing professional education, independent public accountants, internal auditors, and corporate accountants should study the forces and opportunities that contribute to fraudulent financial reporting, the risk factors that may indicate its occurrence, and the relevant ethical and technical standards.*



June 29, 1987

**Baird,
Kurtz &
Dobson**

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Gentlemen:

We have read the Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting, April 1987. We appreciate the Commission's willingness to give interested parties an opportunity to comment on its conclusions. The following observations are intended to highlight those conclusions we believe may have fallen short of the Commission's expressed objectives or those with which we disagree.

Certified
Public
Accountants

Recommendations for the Public Company

The "tone at the top" notion cannot be overemphasized. This hits a very important mark. Requiring top management to be knowledgeable about the company's internal control system is wise, but requiring a public report on management's assessment is an invitation for boiler plate response. It is not reasonable to expect a top manager to report to the public that his company's controls are inadequate. It is reasonable to expect that manager to report on controls to the Board of Directors, who can not only ask questions to test that understanding, but also monitor corrective action. That would be a better approach.

We do not believe a code of corporate conduct will achieve very much. Employees do not take their cues about their employer's expectations from personnel handbooks; they imitate what they see around them. A corporate record of tough enforcement of candid reporting and accounting standards will achieve the correct tone rather than adopting a list of bromides.

Internal auditing can be very effective in a variety of situations, but making such a function mandatory is excessive. The size and complexity of a company should dictate the need for internal auditing. The control environment should dictate the nature of internal audit work. This function should be expected to vary in emphasis and intensity with differences in companies. We think insisting on the function for even the smallest public companies without specifying what the function is to achieve will create an ineffective activity that could actually increase the risks of undetected fraud.

304 McDaniel Bldg.
PO Box 1866
Springfield,
Missouri 65805-1866
417.831.7283

With Offices In:
Arkansas
Kansas
Missouri
Nebraska
Oklahoma
Texas

National Commission on Fraudulent
Financial Reporting
Page 2
June 29, 1987

We believe placing a major responsibility for vigilance against fraud on the Board of Directors is correct. It should be the Board's choice whether that responsibility is delegated to the audit committee.

The Draft attempts to create an internal policeman in the form of the audit committee of independent directors. How can independent directors without the first hand benefit of audit procedures or management responsibility be adequately equipped to achieve the oversight role described in the Draft? If this notion were adopted, how would an independent director fulfill a requirement of "due care" in his duties? With the "right" to employ independent counsel, when would that duty be required? We suggest that the result of this would be to shift responsibility away from the Board to the committee.

A better approach is to require the independent public accountant and, if present, the internal auditor to meet with the Board of Directors and make a report on the matters described in the draft. That meeting should include a mandatory opportunity for independent directors to ask questions without management present. That places the responsibility at the correct location and avoids making the Board and the committee adversaries.

The recommendation to form a body to develop internal control standards is disappointing. There is a great deal written about the control environment (even in the larger sense of the Draft). We question whether having another standard setting body will do anything productive other than create more quasi-regulation, internal corporate bureaucracy, and checklists. The call for new standards implies that "control" is somehow a mystery that needs definition. There is no hidden grand design. Instead, there is a need for meticulous understanding of each company's control problems. The "study" of internal control should be in the company's grassroots, not in a book.

We also point out that the Commission has itself recognized that many, if not most, frauds occurred outside the reach of traditional control systems. Consequently, more complex control organizations below top management are not likely to prevent a repetition of past frauds.

Recommendations for the Independent Public Accountant

The discussion of "firm pressures" was not well developed and lacked recommendations that would solve problems. It should be a major concern to all of us that competitive pressures in the auditing profession could compromise judgement or due care. Particularly, the Draft should consider whether those pressures ever prevent using the sea-

National Commission on Fraudulent
Financial Reporting
Page 3
June 29, 1987

soned judgement of veteran audit partners in each risk area. Many who have studied the ESM case believe that more seasoned partner involvement was a major deficiency. The Draft needs to discuss that problem. It also needs to discuss frankly the counterproductive bidding process for audit engagements, and, in particular, the potentially disastrous results of "low balling" or "buying" audit engagements. The omission of this discussion is obvious.

Reorganization of the ASB is a major flaw in the Draft. Moving non-CPA's into an equal voting position just to give the cosmetic effect of "fulfilling the public policy aspects" is absurd. Audit standards setting is not and has not been a closed club. There has been considerable public airing of the views of the profession on each standard adopted, and the public at large has certainly had the opportunity to provide input. To shrink the ASB and have it dominated by non-CPA's (because the non-CPA's could essentially block any CPA-proposed matter) will not expand or hasten the standard setting process. Also, the potential for large company and large firm dominance of ASB activities is clear in the proposed structure. That not only offers the potential for ignoring the needs of small business and small practitioners, but could lead to accusations of restraint of trade and competition.

It is simply not true that by piling more standards on top of what now exists, we can eventually smother fraud. It is true, however, that by shrinking the standard setting body, moving non-practitioners into a veto position, allowing standard drafting to become a profession within the profession, we can expect standards proliferation, confusion and lop-sided rules that treat public and private companies as if they were all the largest companies in the country.

Matters Not Considered in the Draft

There were other issues we would have liked to have seen discussed in the Draft, including:

1. Discussion of the pressures of constant, quick reporting about financial activity. While quarterly reporting may enhance the public relations and market activity of securities, they also place a very clear pressure for short-term performance. We believe this is a major cause for top management's first unintentional step toward fraudulent reporting. "Making it up in the next quarter" is a real danger that is always a potential in management thinking. A cultural environment that places less emphasis on day-to-day performance and a premium on long-term

quality activity could relieve some of this pressure. It is disappointing that the Draft did not deal in some detail with this problem.

2. Management's Discussion and Analysis is not receiving the attention which it needs. This can be an important tool for communicating the correct interpretation of financial reports. It can be the testing ground for whether the numbers "make sense", yet it is barely mentioned. The quality of MD&A and particularly its candor should be heavily considered in any solution.

Fairness to Small Business

With both disappointment and alarm, we call your attention to the Draft's assertions that small firms and small companies are the real sources of fraudulent reporting. The Draft's only cited evidence for this assertion is in the counting of SEC actions. On page 22 the Draft states "All these findings indicate that any numerical estimate of the incidence of fraudulent reporting would be unsound". In light of that statement, the proposition that nonnational CPA firms are the deficient organizations simply because of the percentage of SEC actions is insulting. One could just as easily make a case that national firms are the culprits because their fraudulent actions are the really big losses, or perhaps one could point out that nearly all national firms have been subject to SEC action while a very low percentage of nonnational firms practicing before the SEC have been acted against. There is a prejudice suggested here that is quite disturbing, and in light of such names as ESM and Penn Square, it is hardly justified.

The core of the matter is that, regardless of size of firm, individual partner performance and willingness to share problems with others is the key to maintenance of quality in any firm. If any firm allows an audit partner to make crucial decisions under pressure without involving independent minds and providing escape valves for the pressure, then the potential for fraud is raised.

That is also true for small business. Top managers can use high level assistants, directors and internal auditors to help deal with pressures, or they can insulate themselves from needed advice. The need for control systems grows with the size and complexity of the company; it is not an inverse relationship as the Draft suggests (page 25 - "disproportionately greater risk").

National Commission on Fraudulent
Financial Reporting

Page 5
June 29, 1987

We hope the Draft has provoked debate. We also hope that the Commission will carefully consider the issues raised and make significant amendments to the Draft. By streamlining and supporting the recommendations, focusing on ways to attack causal factors, and discriminating between cosmetic proposals and substantive, practical ideas, the Draft can be amended to achieve many more of the Commission's and the profession's objectives.

Baird, Kurtz & Dobson



SCHOOL OF BUSINESS
MANHATTAN COLLEGE PARKWAY
RIVERDALE, NEW YORK 10471
(212) 920-0223

91

ACCOUNTING DEPARTMENT
WALTER O. BAGGETT, Ph.D., CPA
CHAIRMAN

29 June 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen,

As my letterhead indicates, I am an accounting academician. I also maintain a small but active accounting practice in order to maintain a level of real world auditing experience. I have attached a printout of my current resume to provide any additional information you might wish regarding my background.

I have read with interest the April 1987 exposure draft of your report. Before I begin my commentary, may I say that while it is no literary treasure, it is a reasonably well written document. I was able to follow the logical development of your recommendations as well as the explanation of their intent.

I have naturally found some difficulty in organizing my comments since I have so many. In general you will see that my principle area of interest is internal control. This is where most of my comments are directed.

One of the prime sources of difficulty is that you present conclusions in many places before you present details. That leaves a commentator the difficult position of hoping that you will provide the promised detail later on. If you do not, and a commentator does no notice the lack of follow up, the comment may be lost.

Given this difficulty, I will present my comments serially, following your test. At time some of the comments may be covered later. If they are not, the comment will not be lost. More than likely, when the later detail does come up, I will be able to expand my commentary. (P.S.: I define a Paragraph as any sub-heading, including recommendations as well as widows from the previous page.)

Page 7, Para. 3.

First no matter how much tone there is at the top there must be detailed substance to the system designed in detail. Next, while I know it is mentioned later, compliance with the Foreign Corrupt Practices Act (FCPA) should be mentioned immediately.

Most important of all, despite my looking for it, I never came accross this "private sector body to provide future guidance on internal controls." Maybe you do recommend this later, but it did not seem to come up in my reading.

Page 8, Para. 1.

You indicate that the audit committee should also oversee the company's system of internal control. Begining here and into the detailed report, you never suggest how that should be done. As we shall see this is an ongoing problem.

Page 9, Para. 2.

You use the phrase "Peer review should be strengthened..." I have always had the lurking fear that we really do not know how effect peer review is. There seems to be a feeling that perhaps more is better. I would in particular suggest that the accounting profession go outside itself to other professions and study in detail how they conduct peer reviews.

Page 11, Para. 3.

I agree there is a particular need to increase the coverage of internal control throughout the business and accounting curricula. As we shall perhaps see, currently it is only mentioned in the first course in the discussion of accounting systems and then does not come up again until auditing. I believe the most important area where its impact must be felt is in the Computer Information Systems courses. These academicians should be addressed specifically in your findings, and not lumped with the other business faculty.

Page 28, Para. 5.

Once again I must disagree with your findings that tone "is the most important factor." The best analogy that comes to mind is the weakest link in the chain. Tone in my view has been the missing link in many frauds, but that does not make it the most important. No matter how honorable the intentions of management, without the proper detailed structure of accounting systems and control, financial reporting will be poor.

Page 29, Para. 4.

In the last sentence you state the audit committee should review risks. Once again, I would like to suggest you provide some sort of structure for the audit committee. What should they be looking for? Who should they call in? I would certainly suggest outsider review and discussions with operational personnel as well as discussion with management. Asking a fraudulent management what is wrong is like asking the cat to guard the bird!

Page 40, Para 3.

As I anticipated, you finally got around to the FCPA. What is most embarrassing is the way you sold the SEC's proposed comments so short. Let us go back to a literal reading of the proposal.

As I recall the auditing CPA firm would have had to prepare a letter stating that adequate systems of internal control were in effect at the client during the entire year. How that turns into self-incrimination I do not know, unless you do not believe in the watch dog role of the auditor.

Perhaps here the issue may turn. I fear that like diligent auditor search for fraud in the client's operation, the role of the auditor serving as watch dog on client operations and controls has disappeared too. I think both of these points need to be reiterated in the commissions finding.

Page 41, Para. 4.

Here is the type of engagement suggested by the SEC: "opine publicly on a company's system of internal accounting control." As we proceed, I trust you will see why this will probably rarely be done.

Page 43, Para. 8.

At last we find what may be the "private sector body" suggested in your summary of recommendations. I guess this must be it. Who is going to support it? How will it be structured and go about its business. I would suggest you strengthen this finding a good bit so people know what you are talking about. I trust I will be able to provide further suggestions as we go along.

Page 47, Para. 3.

As mentioned above the assumption of management's integrity must go by the boards. While this is easy to say, I feel you must address the fact that you are doing away with a major theoretical underpinning of modern auditing. You must, therefore, acknowledge this fact and indicate that from theory to text to firm policies and procedures manuals, there must be a realignment of the auditing literature.

Page 51, Para. 6-7.

I would like to see you expand this suggestion. I think we all know it is true, but there should be some methods built into the system that would contain these pressures. Perhaps you should look at the competitive bidding environment of audits.

Page 53, Para. 7.

In this communication with the users of financial statements I think we are getting closer to the heart of the issue. I think this kind of communication will be difficult if readers have no idea what internal control is. After all if we need to educate business and accounting students as to the concept, think of how difficult it will be to educate financial statement users.

Page 64, Para. 3.

9/c

I have read Mr. Connor's suggestion on SRO's. Unfortunately, I do not know the details of the law regarding these organizations, and I believe most people do not. I would like to see a brief explanation of what these organizations are or must do. It would help explain most subsequent comments.

Page 65, Para. 3.

The statement that "most independent public accountants are members" of the AICPA is problematic. The issue that many are no longer members because of the histrionics caused by the goings on of the SEC, even though it is for a good cause, would help to clear the air here.

Page 67, Para. 2-3.

Your final conclusion to throw out the SRO baby with the drowning of the organizations water does not seem to cut it. I think more time should be taken to see about tailoring the organization to fit the SRO concept still might work. As has been done with cutting out the division of firms, perhaps a fit can yet be achieved.

I have indicated above I may not understand SRO's well enough. In order to make your argument stick better, I think a little more explaining should be done. This may allow you to sell me on the idea that an SRO would reek too much havoc on accounting's professional organizations.

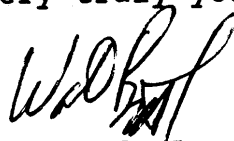
Page 160, Para. 5-8.

At last we have perhaps the heart of the problem; your discussion of what internal control is. Look at it. It is a mumbo-jumbo fo catch phrases and ideas. I would suggest to you that one of the corner stones of my criticism. Quite simply I do not believe there exists a sytematic explanation of internal control. Until such a framework is build nobody can say how much is enough. No firm will be thrilled about putting its signature to an opinion because they can always be second guessed. Until this issue is resolved, I believe you will not be able to resolve the issue you have chosen to address.

Thank you for this opportunity to comment on your exposure draft. It was fun reading, if you are an auditor.

Again, thanks and good luck.

Very truly yours,



Walter O. Baggett
M.B.A., Ph.D., CPA

91d

RESUME

Walter O. Baggett
Associate Professor &
Chairman, Department of Accounting and Law
Manhattan College
Riverdale, New York
10471

I. EDUCATIONAL BACKGROUND

Graduate: University of California, Los Angeles
Graduate School of Business Administration
Masters of Business Administration
Major: Finance
1968

University of North Carolina, Chapel Hill
School of Business Administration
Doctor of Philosophy
Major: Organizational Behavior
1973

Undergraduate: Hanover College
Bachelor of Arts
Major: Business Administration
1966

Professional Certification: Certified Public Accountant
North Carolina 1973
New York 1975

II. PROFESSIONAL/BUSINESS EMPLOYMENT

A. Educational Institution:

Manhattan College
Associate Professor and Chairman of the Department of
Accounting and Law
1983 - Present

Fairfield University
Associate Professor of Finance and Management
1981 - 1983

Baruch College, City University of New York
Assistant Professor of Accountancy
1978 - 1981

Carolina Population Center
Research Associate - Cost and Incidence of Pregnancy in
Industry Project
1972

University of North Carolina, Chapel Hill
Teaching and Research Assistant
1969 - 1971

University of California, Los Angeles, School of Public
Health
Junior Statistician
1967 -1968

B. Business

New York Times Company
Senior Internal Auditor
9/76 - 9/78

Performance of Financial and Operational Audits
including EDP auditing.

Operational audit of WQXR programming function and the
New York Time Information Bank.

Health Examinetics
Controller
3/76 - 10/76

Total financial responsibility for a mobile, multi-
phasetic health testing organization with a branch in
California and health testing units throughout the
country.

Donaldson, Lufkin & Jenrette
Assistant Controller for Accounting Systems
10/75 - 3/76

Responsible for financial reporting systems for a major
brokerage firm including bringing on line a
minicomputer bond system.

Solomon Brothers
Senior Internal Auditor
5/75 - 10/75

Worked on routine brokerage audits and a number of
special systems review of extremely sophisticated
brokerage back room systems.

Ernst & Whinney
Senior Accountant
1/73 - 5/75

Audit staff member doing full variety of audits including banks, brokerage, corporate headquarters, not for profit and other audits.

Peat, Marwick, Mitchell & Co.
Audit Intern
1/68 - 3/68
Audit experience during winter term while completing MBA

C. Professional Consulting

A T & T, Information Systems Division, Custom Programming Support Service Center, Valhalla, N.Y.
Providing Accounting advice and support in the development and installation of computerized accounting systems

Accounting Practice:
Membership in the Professional Achievement Registry of the New York State Society of Certified Public Accountants

Clients: Hudson Valley Day Care Center, Christian Camps, Inc, Greenburg Presbyterian Church, Various private individuals

Preparations of financial statements, audits and tax returns on a limited basis to maintain "partner level" exposure to operation of an accounting practice. These continuing relationships have maintained a currency in actual audit, accounting and tax practice experience.

Carrie S. Finlayson
Audit Assistance
Planning and supervision of audits for a CPA who specializes taxation. This includes research in accounting problems, supervision of audit staff, and preparation of opinions. This exposure provides live experience to staff pressures existing in current practice.

D'Arcangelo & Co.
Staff Specialist
Variety of technical assignments with regional CPA firm including purchase and supervision of Continuing Professional Education programs, reviews and opinions on internal control, brokerage filings, firm policy manual, as well as general tax, audit and accounting work.

Kent Publishing Company
Editorial Reviewer
Review for Third Edition of Porter & Perry's EDP: Controls and Auditing.

Business Publications, Inc.
Editorial Reviewer
Review for Second Edition of Apple Blossom Cologne Company, Audit Case

Joseph Eisdorfer & Co.
Senior Associate
Part-time accounting work with a three-partner New York City firm. Include monthly write-ups for clients and complete range of tax return preparation as well as handling specialized audits such as pension funds and large inventories.

III. PROFESSIONAL ACTIVITIES

A. Professional Organization Activities

American Accounting Association
Member, Membership Committee 1984 - 1985
Member, Administrators of Accounting Program Group
Attended 1984, 1985, 1986 & 1987 - Administrators of Accounting Program

1984 New Chairman's Seminar.
This membership assures that the accounting program maintains the maximum currency with other academic institutions.

Auditing Section:
Vice Chairman, Northeast Region 1982 - 84
Coordinations of Northeast Region Audit Section activities providing contact with all major auditing researchers in the area.

Member Auditing Standards Subcommittees 1982-
Assignments through current work on levels of assurance subcommittee provides exposure to current literature proposals in auditing and to academicians working in the area.

Editor of the "Have You Seen?" Section of the Audit Report 1984-
A summary of all auditing related articles published during the last four months.

Paper Discussant 1982 Northeast Regional Meeting
 Attended 1978 - 1985 Northeast Regional Meeting
 Attended 1980 - 1984 National Meeting
 Regular attendance at these meetings has meant continued contact with the leaders in professional and research activities that has been reflected in my own research.
 Ad Hoc Reviewer 1980 for The Accounting Review

American Institute of Certified Public Accountants
 Member Audit Testing Techniques Subcommittee of the Auditing Standards Board (Formerly the Statistical Sampling Subcommittee) 1984 - 1986
 Member Inherent Risks Task Force 1984 - 1986
 Work on this subcommittee of the Auditing Standards Board (which write U.S. Generally Accepted Auditing Standards) provides exposures to the nations most prominent practitioners and researchers in developing the forthcoming authoritative auditing literature.

New York State Society of Certified Public Accountants
 Member Statistical Sampling and Other Quantitative Methods Committee 1975 - 1978, 1985 - Chairman beginning in 1986
 Continuation of work with quantification of auditing procedure in the profession, Liaison with associated AICPA committee.

Member Relations with Higher Education Committee 1984 - 1986
 As a member of this committee, I represent the College's view in the shaping of the State Society's policy toward higher education. In addition to fighting the five year requirement for the CPA certificate, I am working on a guide to Colleges for CPA firms to improve recruiting on campus by small practice units.

Member Publications Committee 1982 - 1985
 Society on a committee responsible for the budget of the CPA Journal

Member Auditing Standards Committee 1978 - 1981
 Review at state level of forthcoming auditing standards

Faculty Bank; Teaching Statistical Sampling Course
 Westchester County Chapter

Member Accounting And Auditing Procedures Committee 1982 - Chairman beginning in 1986
 Putting on annual accounting and auditing update for local practitioners

Member Accounting Careers Committee 1983 -
 Arranging annual chapter meeting for area college students to introduce them to local job opportunities in accounting

National Association of Accountants
Westchester Chapter, Director of Manuscripts 1984-
Responsible for manuscript solicitation and
presubmission review

American Psychological Association
Attended 1979 National Meeting
Review of literature to maintain currency in
this allied discipline

Volunteer for Volunteer Urban Consulting Group, Inc. on
three separate minority business consulting
projects: Pretty Body, Inc.
Puerto Rican Association for Community
Development
Dominican Sisters of the Sick Poor

Member American Academy of Management
Maintenance of relationship with this important
allied discipline

D. Professional Program Presentations

A T & T, General Business Systems
July 1985
Challenges Facing the Accounting Profession

Westchester Chapter National Association of Accountants
November 8, 1984
Internal Control In A Corporate Environment
This presentation also made to Gaines Foods
Division of Anderson Clayton in February 1986

Westchester Chapter New York State Society of Certified
Public Accountants Accounting and Auditing Update
December 1, 1984
SAS # 39 Effect on Non-statistical Sampling

IV. PUBLICATIONS

A. Refereed Journals

"Using Time-Sharing Facilities for Statistical Sampling",
CPA Journal, October 1977, Vol. 47, No. 10, p. 85
This article has been reference in Audit Sampling audit
guide published by the AICPA

"Operational Auditing: A Management-Based Approach", The
Internal Auditor, February 1982, Vol. 39, No. 1, pp.44-45
This article takes traditional management concepts and
applies them to important auditing problems

"Internal Control: Insight from a General Systems Theory Perspective", Journal of Accounting Auditing and Finance, Spring 1983, Vol. 6, No. 3, pp.227-223

This article represents a cross over of knowledge from the behavioral area and represents a major restructuring for the profession in its approach to this concept

"Using Templates in Accounting and Auditing With Microcomputers", National Public Accountant, May 1985

This article represents a new thrust in publications with the addition of computer expertise to those aspects of accounting and auditing where I have build my professional reputation.

B. Other Journal Articles

"Internal Control: Some Practical Applications from a General Systems Theory Perspective", Manhattan College Journal of Business, Spring 1984, Vol. 12, No. 2, pp.30-33

A further development of ideas presented earlier that need to be sold to the profession

C. Other Publications

Book Review of Statistical Auditing, by Donald M. Roberts, AICPA Publisher, CPA Journal, January 1979, Vol. 49, No. 1, p. 72

A review of a major publications effort of the Statistical Sampling Subcommittee that was in essence a failure in its attempt to educate the profession

Associate Editor, Current Auditing Literature and Author of "Have You Seen" section of The Auditor's Report, Fall 1984, Vol. 8, No. 3 To Present

This quarterly publication requires that I review all current auditing literature and summarize the better ones.

92

TEXAS INSTRUMENTS



June 29, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006

Gentlemen:

We appreciate the opportunity of commenting on the exposure draft of the Commission's report. The Commission, composed of Messrs. Treadway, Batten, Kanaga, Marsh, Storrs and Trautlein, and its staff are to be commended for the significant effort expended and results obtained. On balance we find the Commission's recommendations to be reasonable. In fact, many of the recommended procedures are already in place at Texas Instruments (and likely many other large, well controlled firms).

We do, however, have comments regarding certain of the Commission's recommendations, as follows.

Recommendation: For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

Comment: The discussion of this recommendation in the exposure draft notes that the process of identifying, understanding, and assessing the company's risk environment and internal controls should be part of an ongoing procedure, rather than a separate management project. We agree. However, the draft then notes that the CEO and CFO "must supervise" that procedure. We believe these positions are contradictory. Certainly the CEO and CFO will help set the ethical tone of the company and provide general oversight of the ongoing control/environment review as well as other financial reporting activities. But to require of them a supervisory role in this ongoing procedure is impractical and unnecessary. We are concerned this emphasis on CEO/CFO involvement will encourage extensive and expensive special projects to document companies' controls and environment reminiscent of similar projects a few years ago in reaction to the Foreign Corrupt Practices Act.

We suggest the CEO/CFO discussion be revised to reflect that their general oversight role in the review process is sufficient.

92a

Recommendation: Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.

Comment: According to the draft, a suggested criterion for an effective internal audit staff is compliance with standards of the Institute of Internal Auditors (IIA). We concur, with one exception: the IIA requirement for periodic review. There is currently considerable debate within the internal auditing profession as to the cost effectiveness of this particular procedure. Its implementation has been limited. Securing qualified internal auditors who can commit the necessary time is difficult. And, the use of external auditors to conduct peer review on internal audit organizations has generally been unsatisfactory. Another concern is that internal auditors frequently review proprietary operational procedures that must remain confidential within a select employee group. We believe external peer review is likely an uneconomical procedure that could risk competitive harm.

We suggest that the endorsement of external peer review be eliminated.

Recommendation: Public companies should ensure that their internal audit functions are objective.

Comment: In the discussion of this recommendation the Commission encourages an organizational structure whereby the chief internal auditor would report directly to the CEO or a senior officer who is not directly responsible for preparing the company's financial statements. The stated purpose is to enhance auditor independence. We believe this is an emphasis of form over substance. Auditor independence is basically derived from unrestricted access by internal audits to the audit committee and the CEO. The reporting structure is secondary. In terms of efficiency and effectiveness, it may be preferable for internal audits to report to a financial executive, such as the CFO, who is fully conversant with ongoing financial issues.

We suggest the emphasis in this section be redirected from organizational structure to the basic source of independence: unrestricted access.

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's

assessment of the effectiveness of the company's internal controls.

Comment: It appears that the Commission has attempted in some degree to immunize this recommendation from the criticisms leveled at the SEC's management-report proposal withdrawn in 1980. Our principal criticism of the SEC proposal was that the SEC had not shown that the proposed reports were needed. We stated, "Until the [SEC] comes forth with some real evidence indicating the need for the reports, we believe there should be a presumption against the issuance of regulations requiring the reports." We believe this criticism, at least, is applicable to the Commission's proposal as well as the SEC's proposal.

Moreover, the objective of the Commission's proposal seems to be a management guarantee, rather than a report, regarding internal controls. For example, the management report used as an illustration in Appendix L to the Commission's report has the CEO and CFO categorically stating that the financial statements "are not misstated due to material fraud or error." Absent dishonesty, recklessness or naivete, it is difficult to understand how they could go beyond stating their belief that the company's internal controls provide reasonable assurance that the financial statements are not materially misstated due to fraud or error.

Likewise, in the illustration, the CEO and CFO state that the system of internal control "provides reasonable assurance" as to, among other things, the detection of fraudulent financial reporting. Again, it would seem that their statement should be limited to their belief or, preferably, to a representation that the system of internal control is designed to provide reasonable assurance as to the detection of fraudulent financial reporting, etc.

We recommend that the Commission either drop the recommendation regarding management reports or follow many of the current models of reports, based on the guidelines of the Financial Executives Institute, that include statements such as: "The Company maintains a system of internal controls designed to provide reasonable assurances that its records include the transactions of its operations in all material respects and to provide protection against significant misuse or loss of Company assets."

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

92c

Comment: As discussed above, if a management report is to be required, we favor the FEI-based management report model. As that model contains a description of the audit committee functions, this proposed letter would be redundant. We see no need to include numerous internal representations in the annual report. One is sufficient, as a complement to the independent auditor report.

Recommendation: The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.

Comment: We are concerned about the cost of extending the external auditor's efforts to explicitly search for fraud. This differs from the current auditing guidance contained in SAS No. 16 which calls for the auditor to gauge the fairness of the financial statement presentation including the likelihood that fraud has distorted that presentation. We think this change could result in a significant increase in ongoing audit fees with no equivalent benefit in return to the vast majority of companies not engaging in fraudulent reporting.

While the Commission states in the Summary of Recommendations section that "...the benefits justify the costs", in this instance we remain unconvinced. We suggest the Commission attempt a cost/benefit analysis of this recommendation. Certainly, the costs will be available through company and auditor estimates. This recommendation should be dollarized before it is released as part of the final report. We believe its cost efficiency is questionable.

We would be pleased to discuss our comments with the Commission or its staff as appropriate.

Sincerely,



Marvin M. Lane, Jr.
Vice President and
Corporate Controller



ANHEUSER-BUSCH COMPANIES

Osmond Conrad
Vice President and Controller

June 29, 1987

Mr. G. Dewey Arnold
Executive Director
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Mr. Arnold:

We are pleased to offer our comments on certain aspects of the April, 1987 Exposure Draft titled "Report of the National Commission on Fraudulent Financial Reporting". In releasing the Exposure Draft for public comment, the National Commission on Fraudulent Financial Reporting ("Commission") indicated it hoped to generate reactions, suggestions and opinions from those concerned with or affected by fraudulent financial reporting. As a major publicly owned corporation, our company and the Audit Committee of our Board of Directors is extremely interested in the subject of external financial reporting. As such, we commend the Commission in its work to date and its primary goal of identifying the major factors contributing to fraudulent financial reporting practices and the extent to which they can be prevented and at least detected.

We believe for the most part the Exposure Draft represents a good summary of the steps public companies should consider implementing in order to minimize the possibility of fraudulent financial reporting. However, we also believe that certain comments/suggestions contained in the Exposure Draft are overstated and unrealistic such that their implementation could result in a substantial burden on the company and its Audit Committee without clear benefit to the company or its shareholders.

The specific statements to which we refer and which represent the focus of our comments are as follows:

- Characterization of the Audit Committee as being the primary vehicle used by Board of Directors to discharge their responsibility with respect to the company's financial reporting; and
- The chief internal auditor should report administratively to a senior officer who is not directly responsible for preparing the company's financial statements.

Audit Committee Responsibilities

Anheuser-Busch strongly supports the Audit Committee concept and we support the general guidelines outlined in the Exposure Draft (Appendix K, page 184) on the structure and function of the Audit Committee. However, we believe the statements in the Exposure Draft (on pages 35 and 183) that (a)

the Audit Committee is the "primary vehicle that the Board of Directors uses to discharge its responsibility with respect to the company's financial reporting" and (b) the Audit Committee "represents one of the most effective influences for minimizing fraudulent financial reporting" are unrealistic and misleading. We believe these statements considerably overstate the role played by the Audit Committee.

Audit Committees generally meet no more than three or four times a year. As such, Audit Committees necessarily must rely on the company's system of internal control and information supplied to them by senior management, internal audit representatives and independent certified public accountants ... all of whom spend full time performing their duties and responsibilities. These factors (internal control, management, internal auditors and external auditors) all overseen by the Audit Committee, constitute the primary vehicles used by the Board of Directors to discharge their responsibility with respect to the company's financial reporting. To state that the Audit Committee itself is the primary control vehicle with regard to the integrity of the company's financial reporting is incorrect and would expose such Committees to an unfair burden from litigation due to any fraudulent activities which might take place at lower levels within a company.

Finally, if the Audit Committee is truly designed to be the primary vehicle for monitoring financial reporting, persons serving on such Committees will be required to hire their own full-time staff to fulfill their role or resign from the Committee. No knowledgeable individual would want to serve on an Audit Committee and bear the responsibility of primary control without having full-time staff to perform the necessary control functions. Such a situation would precipitate a chaotic environment of divided responsibilities at a considerable cost to the company, as well as make it very difficult to attract qualified individuals to serve on Audit Committees.

The solution to this problem would be simply for the Commission to revise the wording on pages 35 and 183 of the Exposure Draft to more accurately and realistically describe the role of the Audit Committee and its relationship with the true primary vehicles used to control the company's financial reporting process.

Internal Audit Function Reporting Relationship

The Exposure Draft recommends that the chief internal auditor report directly to a senior official who is not directly responsible for preparing the company's financial statements ... preferably the Chief Executive Officer. However, the Exposure Draft acknowledges that such an organizational structure (i.e. direct day to day reporting to the Chief Executive Officer) may be impractical in larger corporations. We agree and suggest that the Exposure Draft place less emphasis on the organizational structure/reporting relationship of the chief internal auditor and devote more attention to the internal audit function. We believe a reporting relationship of the internal audit function to the chief accounting officer in many cases is well justified and effective due to the intimate knowledge the chief accounting officer has of the company's operations and accounting/reporting functions. The chief

93b

Mr. G. Dewey Arnold

- 3 -

June 29, 1987

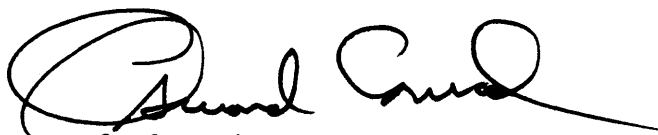
accounting officer is the management official in the best position to effectively direct the internal audit function to those areas most meaningful and important to the integrity of the financial reporting process.

Numerous other controls/procedures are available to ensure the integrity of the internal audit function other than organizational reporting relationships. These controls/procedures include direct and unrestricted access to the Chief Executive Officer and Audit Committee, as well as periodic and private meetings with such persons. To restrict and eliminate a sound and meaningful reporting relationship simply for appearance sake is short-sighted and in the long term would be detrimental to the internal audit function and financial reporting process.

* * * * *

We appreciate the opportunity to comment on these issues and would be pleased to elaborate on any of the foregoing should you desire us to do so.

Sincerely,



O. Conrad
Vice President and Controller
(Chief Accounting Officer)

OC:cp



THE AMERICAN UNIVERSITY
WASHINGTON, DC

June 29, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Ave., N.W.
Washington D.C., 20006

Dear Sirs:

I have reviewed the Exposure Draft Report of the National Commission on Fraudulent Financial Reporting and commend you for preparing such a thoughtful document regarding this important problem. It is particularly gratifying that the Commission recognizes the role of education in reducing the risk of fraudulent financial reporting. I am pleased to provide you with the following comments pertaining primarily to the Commission's recommendations for education in the hope that they will be helpful to the Commission in preparing its final report.

First of all, I believe the Commission has well defined the multidimensional nature of fraudulent financial reporting and has properly prioritized the roles of participants in the financial reporting process. I fully agree, for example, that the overall tone set by top management "is the most important factor contributing to the integrity of the financial reporting process" and that "independent public accountants play a crucial, but secondary role." It is consistent and proper, therefore, for the Commission to focus most of its recommendations for education on general business as well as accounting curricula. Clearly attention to ethics, better understanding of internal controls, and exposure to the problem of fraudulent financial reporting should permeate the business curriculum. In my experience, these topics are currently emphasized much more strongly in accounting courses than in any other area of business education. While even greater emphasis is needed in the typical accounting curriculum, it appears to me that it is the non-accounting segment of the business curriculum which is in greatest need of revision to foster knowledge and understanding of fraudulent financial reporting issues.

Unfortunately, the general public and business community too often expect the accounting profession to be the ethical policemen of the financial reporting process. Similarly, non-accounting business faculty too often consider fraudulent finan-

The Kogod College of Business Administration
Accounting Department

cial reporting to be an "accounting" problem. In order to significantly improve the financial reporting environment, fundamental changes in these misperceptions are necessary. In essence, top management as well as financial, marketing and other business managers must accept their share of responsibility for the incidence of fraudulent financial reporting. Similarly, non-accounting business faculty need to recognize the relevance of financial reporting issues to their disciplines and develop their own personal competence as well as classroom materials to properly convey an understanding of fraudulent financial reporting issues to their students. The business and academic communities cannot be allowed to pass the buck to accounting professionals and educators if they are serious about reducing the incidence of fraudulent financial reporting.

The Commission correctly recommends that business and accounting curricula should promote better understanding of internal controls and ethical values. In a general sense, internal controls provide a defensive mechanism against fraudulent financial reporting while ethical values provide a broad positive rationale for responsible behavior. Of the two, I believe that emphasis upon ethical behavior is paramount since no system of internal control can fully prevent fraudulent acts by dishonest people. Nevertheless, great emphasis on internal controls is essential in business and in academe given the imperfect ethical climate in our society and the difficulty of inculcating sound ethical values in a formal educational setting.

Clearly, one course in business ethics is "too little and too late." Unfortunately, the same can be said about the entire college curriculum. By the time students enter college, their basic ethical norms have long been established. I have found it extremely frustrating to discuss ethical issues in my classes because a large proportion of today's students consider the topic to be "academic" in the worst sense. This attitude is hardly surprising given the materialistic values which pervade our society in general and media depictions of business in particular. In this environment fraudulent financial reporting cannot be regarded as a unique phenomenon. Rather, it is a problem which is symptomatic of a society which increasingly accepts (and sometimes seems to glorify) manipulation, corruption, and basic dishonesty, not only in business, but also in public service and private life.

In my judgment the most effective way to encourage sound ethical values is to provide young people with exemplary role models. Obviously, this should begin at home with parents who are responsible participants in business and society. Sound values can be further fostered by media attention to corporate executive officers, professional accountants and other business leaders who have demonstrated exemplary ethical conduct. And educators can teach best by their example in dealing with academic dishonesty and maintaining the highest standards of integrity on and off campus. The development of better case studies for classroom discussion will certainly help - particularly if

946

such cases illustrate examples of personal and corporate integrity as well as the more publicized cases of fraudulent activity.

The first part of the AICPA Code of Professional Ethics is a philosophical statement which contains, in my opinion, the two most important sentences in the accounting literature:

"Ethical conduct, in the true sense, is more than merely abiding by the letter of explicit prohibitions. Rather it requires unswerving commitment to honorable behavior, even at the sacrifice of personal advantage."

Better understanding of internal control, knowledge of regulation and law enforcement, and the study of corporate and professional codes of conduct are sound recommendations for improving business and accounting curricula. But it is the thought expressed in the second sentence of the above quotation which should be emphasized in educational efforts to reduce fraudulent financial reporting and other unethical business practices.

As a final comment, I must express my disappointment at the Commission's failure to take an unequivocal position in support of a five year educational requirement for entry into the accounting profession. The Commission correctly observed that the recommended expansion of the accounting curriculum to deal with fraudulent financial reporting should not be at the expense of the liberal arts component of accounting education. The Commission further observed that the explosion of information related to accounting, auditing, and computerized systems necessitates more extensive educational preparation for entry-level positions in the accounting profession. The recommended development of stronger analytical, problem solving and judgment skills also requires a more extensive educational process than is presently available in a baccalaureate program. Additionally, more emphasis on ethics, internal control, and the regulatory and legal environment is advocated. Gentlemen, it is clear to me that these objectives cannot be accomplished within the limitations of a 4-year baccalaureate program.

Please note that I do not advocate a 5-year program for all accounting students. A 4-year baccalaureate program is appropriate for accounting as well as for other business majors. However, for those students aspiring to become CPA's, a fifth year of study should be mandatory. In devoting an entire chapter of its report to recommendations for the Independent Public Accountant, the Commission recognizes that the role of the practicing CPA is more demanding and complex than that of the entry-level corporate accountant. In my judgment, a fifth year of study is absolutely necessary to adequately prepare students for entry into the accounting profession as certified public accountants. The Commission would best serve the public interest by taking a strong position in favor of this expanded educational requirement for professional certification.

I appreciate the opportunity to share the above comments with the Commission and look forward to the issuance of your final report.

Sincerely

A handwritten signature in cursive script that reads "Philip F. Jacoby".

Philip F. Jacoby, Chairman
Department of Accounting

PJ/dp



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

JUN 29 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Sir:

Thank you for the opportunity to comment on the Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting.

The Commission's report is a valuable compilation of the situations which allow fraudulent financial reporting to occur and provides viable solutions to the problem. If all the recommendations are implemented, fraudulent financial reporting by public companies would become less likely. My recommendation is that the Commission identify specific organizations, including government agencies, and receive from them a commitment to be responsible for overseeing implementation of the recommendations. Although the commitment would not be legally binding, it is a way to maintain the momentum towards eliminating fraudulent financial reporting.

I also offer the following suggestions for your consideration:

1. As noted in the report, the AICPA has issued proposed standards concerning studies of internal controls and requirements to develop procedures to detect fraud in audits and to use analytical procedures. The Commission should consider not issuing its final report until after the proposed standards are issued in final form. This would allow the Commission to comment on whether the AICPA's new requirements adequately address the Commission's recommendations.
2. The Commission should consider a recommendation to require a CPA firm to report to the audit committee instances of fraud detected during a MAS engagement if the firm is also engaged to perform an audit.

Page 2

The requirement would help overcome the objection to allowing CPA firms to conduct MAS and audit engagements at the same time.

Again, thank you for the opportunity to comment on the exposure draft.

Sincerely,

James B. Thomas, Jr.
James B. Thomas, Jr.

96



200 South Orange Avenue, Livingston, NJ 07039
Telephone 201-533-7787

Joseph G. Wojak
Executive Vice President

EXPRESS MAIL

June 29, 1987

The National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

I am writing on behalf of the Howard Savings Bank, a diversified financial services organization with total assets of \$4.4 billion. I serve as the Chief Financial Officer of this organization and am a Certified Public Accountant of the State of New Jersey.

We applaud the Commission's intentions in trying to prevent and deter fraudulent financial reporting. One need only review business periodicals of the recent past to see the importance of achieving that objective. We feel, however, some of the Commission's proposals could be too costly and impracticable.

The Commission recommends the Chief Internal Auditor (the "Auditor") report to the Chief Executive Officer (the "CEO") who would meet with the Auditor on a quarterly basis. We perceive no benefit to this arrangement. An Auditor with a direct relationship to the Audit Committee of the Board of Directors has an established independence of operation. Secondly, the American Institute of Certified Public Accountants' Code of Professional Ethics and established practices in industry fortify this independence. Lastly, auditing is still quintessentially a financial function. Active involvement with the Chief Financial Officer and other financial groups within the organization provides necessary channels of information to the Auditor, as well as providing alternative career paths for the young professionals in the Auditing Department. The limited time a CEO can devote to the Auditor is not sufficient to insure the effectiveness of this function.

The Commission also recommends the annual report contain letters from Management and the Chairman of the Audit Committee on the

96a

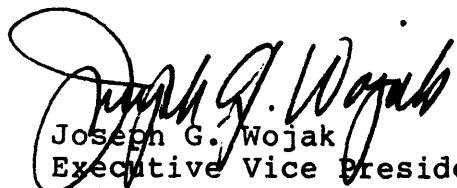
The National Commission on
Fraudulent Financial Reporting
June 29, 1987
Page 2

adequacy of internal controls. To the best of our knowledge, we do not know of any empirical evidence which suggests these letters will enhance the quality of disclosure in the annual report to shareholders. The annual report, proxy, and Form 10-K already provide volumes of information about any company.

Additional information such as what the Commission suggests should be added only if there is a clearly demonstrated need of the various stakeholders of the company which must be satisfied. We do not perceive this to be the case.

We respectfully ask the Commission to re-examine these issues in light of the potential costs and benefits of implementation. On the whole we applaud the Commission's findings and recommendations as a welcome addition to corporate financial practices.

Very truly yours,


Joseph G. Wojak
Executive Vice President &
Chief Financial Officer

JGW:mam



E. I. DU PONT DE NEMOURS & COMPANY
INCORPORATED

WILMINGTON, DELAWARE 19898

June 29, 1987

VICE PRESIDENT AND COMPTROLLER

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue
Washington, D.C. 20006

Gentlemen:

This letter responds to your request for comments on your April 1987 Exposure Draft Report of the National Commission on Fraudulent Financial Reporting. Our overall reaction to the Report is very favorable. We believe your Commission has done an outstanding job in identifying causes of fraudulent financial reporting and in suggesting ways to prevent and detect it.

There are areas, however, in which we question whether your Commission's recommendations are feasible and/or cost effective. For example, we believe the Report would extend the role of audit committees even in many progressive companies. While we agree that audit committee members should be vigilant and informed, there are limitations on what audit committees can be expected to accomplish without transforming their role from an oversight to a participatory one. Also, there is a danger that public expectations of audit committees could be raised to too high a level. In addition, it would subject audit committee members to additional liability. We believe the Report in general might be "toned down" somewhat in this area, and we offer below some suggestions in response to specific recommendations.

A second area of concern is the expanded role that would be created for internal auditors. We strongly support the need for a strong, independent internal audit organization with no restrictions or limitations on their activities. At the same time, their role must be closely coordinated with that of the outside auditors to achieve cost-effective results. There should be no duplication of effort between the two groups. Again, we suggest reconsideration of certain recommendations in this area as discussed further below.

Our comments on specific recommendations are limited to those in Chapter Two: Recommendations for the Public Company and to related Good Practice Guidelines. Other than as noted, we agree with your Commission's recommendations. In other areas of the report we have reviewed and generally agree with the views expressed in the FEI response letter.

97a

Recommendation: For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

Comment: We agree that the "tone at the top" is the key to a successful internal control program. Also, we think the Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting in Appendix H will be very helpful to Du Pont and other companies in guarding against improprieties.

Our only concern in this area is that your Commission's Report not convey the impression that companies need to immediately mount a costly, one-time campaign to document that all areas of concern have been reviewed and that adequate controls exist. We think that is not your intent, but additional commentary in the Report to reinforce that understanding would be appropriate.

Recommendation: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

Comment: We believe that your Report should incorporate the concept of "reasonable assurance" in this recommendation. This would be consistent with other areas of the Report and would also avoid giving the impression that a system of internal controls can be totally effective in preventing fraudulent financial reporting.

Recommendation: Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.

Comment: We strongly support the recommendation that companies maintain an effective accounting function. In the text of the report discussing this recommendation, however, the comment is made that the chief accounting officer (CAO) should be held responsible for fraudulent financial reporting. We do not believe that this is a responsibility that can be assigned to a single individual. The report points out in other areas that fraudulent financial reporting can be perpetrated by various individuals in the organization, including the CEO, who may be acting individually or in collusion with others. In such situations, the CAO may have no knowledge that fraudulent reporting is taking place -- at least in the near term. Thus, while we agree that the CAO may have primary responsibility in this area, it should be recognized that this is a shared responsibility, and the CAO, despite his best efforts, may sometimes be unable to prevent fraudulent reporting.

Recommendation: Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.

Comment: We fully support the recommendation, but we do not agree with the comment in the text that would require "peer" reviews every three years. First, we would be concerned about "peer" reviews if the implication is that "peers" would be internal auditors from other companies that might be competitors, customers, or suppliers. This would be unacceptable because of the confidentiality of the subject matter involved. We note that the term "peer" does not appear in the IIA Standard, and we suggest it be dropped from the text of the report.

Further, while we support the notion of periodic external reviews by independent accountants (and in fact have recently undergone such a review by independent accountants other than the Company's), we do not see the need to do this every three years as stated in the IIA Standard. Such reviews are quite expensive, and they cannot be cost justified that frequently. We suggest that your Commission modify the comment in the text that deals with this issue.

Recommendation: Public companies should ensure that their internal audit functions are objective.

Comment: We strongly support the recommendation, but we are concerned about two comments in the accompanying discussion. First, we do not believe that the chief internal auditor necessarily needs to report to someone other than the CAO. The CAO is responsible in many companies for the adequacy of the internal controls. The internal audit organization plays a vital role in ensuring the adequacy of internal controls, and the internal audit organization therefore logically should support the CAO's efforts in this regard. Further, the Report (in another recommendation) would charge the CAO with responsibility for the prevention of fraudulent reporting, but (in this recommendation) would deprive the CAO of the benefit of one of the primary deterrents. We also note that the Report on page 20 identifies companies' top management as being responsible for fraudulent reporting in a large majority of cases and yet recommends that the chief internal auditor report to the CEO. We believe that in most "real world" situations, the chief internal auditor will benefit significantly from the support that the CAO can give him. This extends also to personnel considerations in staffing the internal audit function, since the accounting and auditing disciplines are so closely related. We believe companies should have the flexibility to determine the chief internal auditor's reporting relationship that best suits their circumstances.

Second, we do not believe that the chief internal auditor necessarily needs to have a background as "an experienced audit professional". Many large companies, such as Du Pont, have an experienced, knowledgeable, and highly trained internal audit staff. The function can benefit more from outstanding leadership qualities -- including extensive experience in and knowledge of company operations -- than from mere technical expertise.

Recommendation: Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.

Comment: Again, we agree with and support the basic recommendation. However, we do not believe that there is a need for "appropriate involvement by the internal auditors at the corporate level". This will inevitably result in duplication of effort, because the independent accountants necessarily must directly ensure that the financial statements are prepared in accordance with GAAP. Moreover, involvement at the corporate level requires an in-depth and current understanding of published reporting and disclosure requirements that internal auditors generally do not possess. It would be expensive to require this specialized kind of training for internal auditors -- particularly when it would merely duplicate the role of external auditors. We suggest this reference in the text be deleted. We believe the previous recommendation -- that internal auditors consider the implications of their nonfinancial audit findings for the company's financial statements -- is comprehensive enough that further specific guidance is not required.

Recommendation: The audit committee should approve in advance the types and the extent of management advisory services (MAS) that management plans to engage the company's independent public accountant to perform.

Comment: We agree that the audit committee should be informed of and should evaluate the extent of MAS performed by the independent accountant. This would normally be done as part of another recommendation that the audit committee review the independence of the public accountant. However, the proposed requirement that the audit committee approve in advance the types and extent of MAS would pose administrative complexities in situations where the public accountant's services were required on short notice for any reason -- which might be the case, for example, in connection with proposed acquisitions -- where time is of the essence and

involvement by the company's public accountants in an MAS capacity might greatly facilitate the transaction. We believe it is very important to note that none of your Commission's studies indicated any actual case where independence was compromised because of MAS activities, and we suggest that this be given recognition by modifying the recommendation to require that the audit committee be periodically informed of and evaluate the effect of MAS -- but not to require advance approval.

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

Comment: We support the basic recommendation, but we have concerns about some of the Good Practice Guidelines for Management's Report in Appendix L:

- o The recommended disclosure that the financial statements "are not misstated due to material fraud or error" is redundant and likely to be misunderstood by users. It should not be required.
- o The Guidelines refer to ensuring that other information in the annual report (i.e., other than the financial statements) is "correct" or "accurate". To the extent that such other information is objective and verifiable, we certainly agree that it should be correct and accurate. Some other information, however, such as the future outlook for the business and the discussion of risks and uncertainties, is subjective and judgmental and reflects management's opinions on such matters. We question whether it is appropriate to use terms such as "correct" or "accurate" to characterize such information.
- o The effectiveness of internal controls is an ongoing concern rather than a point-in-time consideration as implied on page 187 and in the illustrative report on page 188.
- o There is usually a time lag in responding to auditors' internal control recommendations, because the nature and cost/benefit relationship of making improvements must be considered. In recognition of this, we suggest that the proposed statement be modified to indicate that management has responded or is considering the auditors' recommendations.

- o The illustrative report includes a comment that all representations made to the company's outside auditors were valid and appropriate. Many contacts take place between a company's employees and the outside auditors during the course of an audit, and management cannot monitor all of these contacts to judge the validity of all representations made to the auditors. We therefore suggest the comment be modified to refer to "management's representations" rather than "all representations".

We are also concerned about the comment on page 41 of the text accompanying this recommendation that the CEO may want to periodically engage the independent accountants to examine the company's internal accounting controls. We have studied this and determined that the added cost of such a supplementary examination cannot be justified. In our own situation, the examination of our internal accounting controls is already adequately covered by our internal audit staff, working in close cooperation with our independent accountants. This includes coordination in planning and review of internal audit procedures and workpapers by the independent accountants. Any further extension of the independent accountant's role would result in duplication of effort. If the Commission believes it desirable to refer to a supplementary examination of a company's internal accounting controls by the independent accountants, we believe it should be clarified that this is something to be considered but may not be cost-justified for all companies.

Recommendation: When a public company changes independent accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

Comment: As a practical matter, we believe it would be virtually impossible for companies to comply with this recommendation because of the multiple contacts and discussions that take place between companies and their independent accountants over a 3-year period. Many individuals can be involved, and in many cases, no written records are made of such discussions. We believe existing SEC rules in this area are adequate.

Recommendation: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

Comment: We believe it is impractical for audit committees to get involved in approving quarterly financial results prior to public release. The primary concern here is the delay that would be involved in releasing earnings information to the public. Delaying the release would be a disservice to stockholders, creditors, and the investing public. Also, we do not think that the audit committee generally has any basis for contributing to the disclosure process. It requires an in-depth knowledge of the company's current operations that only those involved on a full-time day-to-day basis can bring to bear. Again, we believe this would be an unwarranted extension of the audit committee's role from an oversight to a participatory one.

On the other hand, we would have no objection to and in fact would support a recommendation that any changes in significant accounting policies made in interim periods should be cleared with the audit committee before they were adopted.

Recommendation: The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

Comment: If the Commission's recommendation to modify the composition of the AICPA's Auditing Standards Board is adopted, we believe that body could adequately perform this role and thereby avoid the cost of a separate new organization.

* * * * *

As noted above, we support all the other recommendations in Chapter Two and appreciate the opportunity to comment on the Commission's fine work.

Sincerely,


Marcia G. Mand

American Express Company
American Express Tower
World Financial Center
New York, New York 10285



June 30, 1987

The National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Gentlemen:


American Express Company commends the Commission on its exposure draft, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING. As a large publicly held company, American Express already has in place a substantial portion of the Commission's recommendations. This is surely the case for many publicly held companies. Unfortunately, the few well publicized incidents of fraudulent financial reporting have shaken the public's confidence in what is essentially a very ethical and efficient system. We hope that the efforts of the Commission, along with the constructive input of the participants in the financial reporting process, will result in a reduction of the incidence of fraudulent financial reporting and help restore the public confidence that the system deserves. Accordingly, we fully support the spirit of the document. We are concerned, however, that certain recommendations could disproportionately burden public companies without sufficient corresponding benefit.

In the attached appendix are our comments regarding certain of the specific recommendations. For ease of reference, we've also attached Appendix A of the Exposure Draft and numbered each recommendation.

In conclusion, American Express appreciates the opportunity to express its viewpoints on the Commission's outstanding effort.

Very truly yours,


Michael P. Monaco
Comptroller


William W. Warrick
Corporate Auditor

Attachment

RECOMMENDATIONS FOR THE PUBLIC COMPANY

Recommendation 1: For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

We are concerned that this recommendation may be interpreted as calling for the specific implementation of the guidelines included in Appendix H of the exposure draft. The conclusion of the appendix states that the guidelines do not represent a "cookbook" approach. Nevertheless, we believe that Appendix H will inevitably be viewed as a set of model procedures, giving rise to adverse inferences for lack of compliance. Because the factors that are relevant vary considerably from company to company, the use of Appendix H in such a manner would be inappropriate.

In addition, the text relating to the recommendation indicates that individuals at all levels perform parts of the assessment and that top level management (CEO and the CFO) must supervise the process. Typically, substantial documentation of the steps performed and the resultant findings and conclusions would be prepared as part of such a formal process. Top management's awareness of the factors that contribute to fraudulent financial reporting is a fundamental condition that facilitates the implementation of more specific controls. We agree with the tone of the recommendation but suggest that the Commission make it clear that it is not proposing that companies undertake massive and costly documentation efforts of their specific actions in this regard.

Recommendation 2: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

We recommend that the Commission encourage companies to "maintain internal controls that are adequate to reasonably assure the prevention and detection of fraudulent financial reporting". The concept of "reasonable assurance" implies that the cost of implementing specific controls should be commensurate with the benefits obtained and recognizes that no level of internal control could absolutely guarantee against all instances of fraudulent financial reporting.

Recommendation 6: Public companies should ensure that their internal audit functions are objective.

Although we generally agree with this recommendation, we take exception to the suggestion in the accompanying text that a reporting relationship in which the chief internal auditor reports directly to the CEO is generally more desirable. From a practical standpoint, it is often more efficient for the chief internal auditor to report directly to the CFO, who is ultimately responsible for the implementation and operation of control

procedures within the financial reporting process. The objectivity of the internal audit function would not be compromised by such a reporting relationship as long as the chief internal auditor has direct and unrestricted access to the audit committee of the board of directors.

Recommendation 14: The audit committee should approve in advance the types and extent of management advisory services that management plans to engage the company's independent public accountants to perform.

Clearly, the audit committee should be aware of activities that would impair the independence of the company's independent public accountants. However, we disagree with this particular recommendation. In many (if not most) instances, we believe that the auditors' knowledge of their client's business would significantly add value to the quality of management services provided, as well as limit the related costs of such services. The additional knowledge of the company and its operations attained by the auditors through the provision of non-audit services will also enhance audit quality. Consequently, it often makes logical business sense that the auditors provide services outside the scope of the audit itself. This particular recommendation would discourage such actions. We also believe that the perception that such services can impair independence is unfounded.

We suggest that this particular recommendation be deleted. Instead, the text accompanying Recommendation 13 could be expanded to suggest that the audit committee be periodically informed of the extent of management advisory services provided by the independent auditors. Advance approval is, in our opinion, highly impractical.

Recommendation 15: All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

The primary responsibility for the fairness of the financial statements rests with management. The audit opinion that accompanies the financial statements provides investors with the assurance that an independent audit of such statements was conducted in accordance with generally accepted auditing standards. In our annual report to shareholders, an acknowledgment of management's responsibility for the preparation of the financial statements and a brief discussion of the Company's system of internal accounting controls follows the auditor's opinion. We do, however, question the desirability of an SEC rule that mandates such a report. With or without the report, the responsibility of management is the same. The likely result of a specific disclosure requirement is boilerplate narrative, particularly where such a requirement includes

APPENDIX
Page Three

"management's assessment of the effectiveness of the company's internal controls".

We are also concerned that this assessment will require management to document a formal assessment process. Such a process, which would involve substantial costs, would not significantly contribute to the establishment and maintenance of important controls.

If the aim of this recommendation is to increase management's attention to the adequacy of internal controls, we submit that this aim is better served by the Commission's substantive recommendations than by the effect of additional disclosure requirements.

Recommendation 16: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

American Express includes a report by management that addresses management's responsibility for the preparation of the financial statements. We also include a discussion of the membership and responsibilities of our audit committee. These disclosures, together with the report of the independent accountants is, in our opinion, sufficient. The inclusion of a signed report by the chairman of the audit committee places disproportionate emphasis on the role of the audit committee. (Accordingly, we see no need for Appendix M, Good Practice Guidelines for Audit Committee Chairman's Letter.)

Recommendation 17: Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.

There are increasingly more transactions, particularly with respect to financial instruments, for which definitive accounting guidance is not available. In such circumstances, it is management's responsibility to evaluate the propriety of the alternative accounting approaches. In discharging this responsibility, it is management's prerogative to seek input from accounting firms other than the independent auditors. After all, management is directly responsible for the preparation of the financial statements and has a very real stake in obtaining the correct accounting treatment. If the company and its auditors ultimately disagree on the accounting treatment of a material item, the auditors would be unable to opine on the financials without a qualification.

This recommendation implies that management seeks additional opinions on accounting issues for the purpose of identifying the one that will result in the intended financial reporting result. We believe that this is the exception to general practice. Therefore, while we recognize the intent of the Commission on this particular issue, we suggest that it be modified

APPENDIX
Page Four

to address only those instances when management chooses to implement an alternative accounting approach without the concurrence of its independent auditors.

Recommendation 18: When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

Our concern with this recommendation is similar to our concern with Recommendation 17. This recommendation implies that changes in auditors were precipitated by disagreements on accounting issues. This is certainly not the case in all instances. Notwithstanding this concern, the disclosure of all material issues "discussed" is clearly not practical, given the increasing volume of issues for which no definitive guidance exists. We believe that the existing SEC requirements involving detailed disclosure under Item 4 of Form 8-K and in the company's proxy statement are sufficient. If a recommendation along these lines is to be retained, we strongly suggest that it be limited to material issues where disagreements actually occurred.

Recommendation 19: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We strongly disagree with mandatory audit committee approval of financial results prior to public release. The oversight process of the audit committee is one that is ongoing. Accordingly, throughout the year, communications among the audit committee, senior management and the internal auditors and independent accountants should be sufficient to inform the audit committee about significant and/or controversial issues. The formal approval by the audit committee of financial results before public release would delay American Express' timely release of quarterly financial information to the public.

Recommendation 20: The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

The specific design of effective internal controls is determined primarily by the nature of the organization to which they will apply. Given the significant diversity of organizational and operational structures among industries, the design of controls will also vary significantly. We question the need for a body to guide public companies in this area. Guidelines applicable to all public companies will, by definition, be very broad in nature. We don't think that such guidance will be particularly useful. The effectiveness of internal controls can only be determined from within a company.

APPENDIX
Page Five

A general concern we have with this section relates to the overall role of the audit committee. While we recognize and support the role of the audit committee, we strongly believe that this role should be one of oversight. The Commission's recommendations appear to blur the distinction between the oversight role of the audit committee and management's direct responsibility for financial statement preparation. For example, advance approval of management advisory services performed by the independent auditors (Recommendation 14), involvement in the initial stages of accounting research (Recommendation 17) and pre-release approval of quarterly results (Recommendation 19) are, in our opinion, managerial functions. The mandatory inclusion in annual reports, under SEC rule, of a letter from the audit committee chairman, further emphasizes this shift of the audit committee's role away from one of oversight to one of direct involvement. We urge that the Commission reconsider the crafting of these recommendations to avoid this undesirable shift in responsibility. (We also recommend the Appendix K, Audit Committee Good Practice Guidelines, be modified to reflect the comments made above.)

RECOMMENDATIONS FOR THE INDEPENDENT PUBLIC ACCOUNTANT

We support the efforts undertaken by the Auditing Standards Board (ASB), many of which are responsive to the concerns expressed by the Commission. Accordingly, except for the two comments noted below, we defer to the ASB's proposed statements on auditing standards.

Recommendation 23: The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.

The review of financial data prior to public release would, in many instances, slow down the timely release of data valuable to investors. In addition, the extent of the review would be limited due to the resulting time constraints placed upon the auditors. We seriously question whether such a review would significantly reduce the incidence of fraudulent financial reporting. Ongoing and timely communication throughout the year between the auditor and the company would eliminate the necessity for a "quarterly" review.

Recommendation 29: The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice.

We agree with this recommendation. However, in the accompanying text, the second suggestion for implementation indicates that half of the membership of the ASB should be practicing public accountants. While we agree that representation of qualified and knowledgeable persons not engaged in

APPENDIX
Page Six

public accounting will add value to the process, we don't think it is necessary that such representation constitute half of the total membership. The resultant benefit can certainly be achieved with a smaller proportion of the membership.

RECOMMENDATION FOR THE SEC AND OTHERS TO IMPROVE THE REGULATORY AND LEGAL ENVIRONMENT

Recommendation 31: The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.

Although we do not take exception to the thrust of this recommendation, we suggest that "fraudulent" is a more appropriate description than "unsound", which is vague and not grounded in any legal standard, and thus likely to be misinterpreted.

Recommendation 38: The financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant.

A fundamental strength of the audit process is the free flow of information between the auditor and client. Under this recommendation, the independent accountant would effectively be utilized by regulatory agencies as a surrogate enforcement arm. In such circumstances, the relationship between the independent accountant and client may become unnecessarily adversarial in nature. We are concerned that this would hinder the free flow of information, which in turn would negatively impact the quality of audits. We suggest that this recommendation be reconsidered in light of the potential negative consequences.

Recommendation 39: State boards of accountancy should implement positive enforcement programs that periodically would review the quality of services that the independent public accountants they license render.

The existence of an efficient peer review process should eliminate the need for similar activities by state boards of accountancy. The benefits of such an effort, in our opinion, would not be worth the resultant costs.

COMPLETE SET OF RECOMMENDATIONS

Chapter One: Overview of the Financial Reporting System and Fraudulent Financial Reporting

No recommendations

Chapter Two: Recommendations for the Public Company

The Tone at the Top

- 1 **Recommendation:** *For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.*
- 2 **Recommendation:** *Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.*
- 3 **Recommendation:** *Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. A company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.*

Accounting Function and Chief Accounting Officer

- 4 **Recommendation:** *Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.*

Internal Audit Function and Chief Internal Auditor

- 5 **Recommendation:** *Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.*
- 6 **Recommendation:** *Public companies should ensure that their internal audit functions are objective.*
- 7 **Recommendation:** *Internal auditors should consider the implications of their nonfinancial audit findings for the company's financial statements.*
- 8 **Recommendation:** *Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.*

Mandatory Independent Audit Committee

- 9 **Recommendation:** *The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.*
- 10 **Recommendation:** *Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.*

- 11 **Recommendation:** All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it at least annually, and modify it as necessary.
- 12 **Recommendation:** Audit committees should have adequate resources and authority to discharge their responsibilities.
- 13 **Recommendation:** The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.
- 14 **Recommendation:** The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

Reporting on Responsibilities in the Annual Report to Stockholders

- 15 **Recommendation:** All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.
- 16 **Recommendation:** All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

Seeking a Second Opinion

- 17 **Recommendation:** Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.
- 18 **Recommendation:** When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

Quarterly Reporting

- 19 **Recommendation:** Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

Setting Standards for Internal Control

- 20 **Recommendation:** The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

Chapter Three: Recommendations for the Independent Public Accountant

Recognizing Responsibility for Detecting Fraudulent Financial Reporting

- 21 **Recommendation:** The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.

Improving Detection Capabilities

- 22 **Recommendation:** *The Auditing Standards Board should establish standards to require independent public accountants to perform analytical review procedures in all audit engagements and should provide improved guidance on the appropriate use of these procedures.*
- 23 **Recommendation:** *The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.*

Improving Audit Quality

- 24 **Recommendation:** *The AICPA's SEC Practice Section should strengthen its peer review program by increasing review of audit engagements involving public company clients new to a firm. For each office selected for peer review, the first audit of all such new clients should be reviewed.*
- 25 **Recommendation:** *The AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.*
- 26 **Recommendation:** *Public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality.*

Communicating the Auditor's Role

- 27 **Recommendation:** *The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.*
- 28 **Recommendation:** *The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.*

Reorganization of the Auditing Standards Board

- 29 **Recommendation:** *The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practices.*

Chapter Four: Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment

Additional SEC Enforcement Remedies

- 30 **Recommendation:** *The SEC should have the authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding.*

31 **Recommendation:** *The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.*

32 **Recommendation:** *The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company.*

Increased Criminal Prosecution

33 **Recommendation:** *Criminal prosecution of fraudulent financial reporting cases should be made a higher priority. The SEC should conduct an affirmative program to promote increased criminal prosecution of fraudulent financial reporting cases by educating and assisting government officials with criminal prosecution powers.*

Improved Regulation of the Public Accounting Profession

34 **Recommendation:** *The SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SECPS of the AICPA's Division for CPA Firms.*

35 **Recommendation:** *The SEC should take enforcement action when a public accounting firm fails to remedy deficiencies cited in the public accounting profession's quality assurance program.*

SEC Resources

36 **Recommendation:** *The SEC must be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting.*

Financial Institution Regulatory Agencies

37 **Recommendation:** *The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board (including the Federal Savings and Loan Insurance Corporation) should adopt measures patterned on the Commission's recommendations directed to the SEC to carry out their own regulatory responsibility relating to financial reporting under the federal securities laws.*

38 **Recommendation:** *The financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant.*

Enhanced Enforcement by State Boards of Accountancy

39 **Recommendation:** *State boards of accountancy should implement positive enforcement programs that periodically would review the quality of services that the independent public accountants they license render.*

Considering the Implications of Liability on Audit Quality

40 **Recommendation:** *Parties charged with responding to various tort reform initiatives should consider the implications that the perceived liability crisis holds for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting.*

Reconsidering Corporate Indemnification

41 **Recommendation:** *The SEC should reconsider its long-standing position that the corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable.*

Chapter Five: Recommendations for Education

Business and Accounting Curricula

- 42 **Recommendation:** *Throughout the business and accounting curricula, educators should foster knowledge and understanding of the factors that may cause fraudulent financial reporting and the strategies that can lead to a reduction in its incidence.*
- 43 **Recommendation:** *The business and accounting curricula should promote a better understanding of the function and the importance of internal controls, including the control environment, in preventing, detecting, and deterring fraudulent financial reporting.*
- 44 **Recommendation:** *Business and accounting students should be well-informed about the regulation and enforcement activities by which government and private bodies safeguard the financial reporting system and thereby protect the public interest.*
- 45 **Recommendation:** *The business and accounting curricula should help students develop stronger analytical, problem solving, and judgment skills to help prevent, detect, and deter fraudulent financial reporting when they become participants in the financial reporting process.*
- 46 **Recommendation:** *The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting.*
- 47 **Recommendation:** *Business schools should encourage business and accounting faculty to develop their own personal competence as well as classroom materials for conveying information, skills, and ethical values that can help prevent, detect, and deter fraudulent financial reporting.*

Professional Certification Examinations

- 48 **Recommendation:** *Professional certification examinations should test students on the information, skills, and ethical values that further the understanding of fraudulent financial reporting and that promote its reduction.*

Continuing Professional Education

- 49 **Recommendation:** *As part of their continuing professional education, independent public accountants, internal auditors, and corporate accountants should study the forces and opportunities that contribute to fraudulent financial reporting, the risk factors that may indicate its occurrence, and the relevant ethical and technical standards.*

MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036

TELEPHONE (202) 331-8430 • FAX (202) 331-7160

June 30, 1987

PRESIDENT
KENNETH McLENNAN

VICE PRESIDENT AND TREASURER
THOMAS F. RUSSELL Chairman
Federal-Magul Corporation Detroit, Michigan

VICE PRESIDENTS
JOSEPH A. BOYD Chairman
Cris Corporation Melbourne, Florida
ROBERT CIZIK Chrm. and Pres.
Cooper Industries, Inc. Houston, Texas
DAVID T. KIMBALL Chairman
General Signal Corporation Stamford, Connecticut

SENIOR VICE PRESIDENT AND CHIEF ECONOMIST
RICHARD R. MacNABB

VICE PRESIDENT AND SECRETARY
FRANCIS W. HOLMAN, JR.

VICE PRESIDENT—LAW
WILLIAM J. HEALEY, JR.

VICE PRESIDENT—MEMBERSHIP RELATIONS
FRED E. SHAND

STAFF DIRECTOR—INTERNATIONAL
PAUL H. PRATT

STAFF COUNSEL
DONN R. MARSTON

EXECUTIVE COMMITTEE
WILLIAM F. ANDREWS Chairman
SSMC Inc. Stamford, Connecticut

WENDELL F. BUECHE Chrm. and Pres.
Allis-Chalmers Corporation Milwaukee, Wisconsin

JEFFREY J. BURDGE Chairman
Harsco Corporation Camp Hill, Pennsylvania

J. E. CUNNINGHAM Chairman
McDermott International, Inc. New Orleans, Louisiana

DONALD W. DAVIS Chairman
The Stanley Works New Britain, Connecticut

THOMAS I. DOLAN Chairman
A. O. Smith Corporation Milwaukee, Wisconsin

NORRIS K. EKSTROM Chairman
Becor Western Inc. South Milwaukee, Wisconsin

EVANS W. ERIKSON Chairman
Sundstrand Corporation Rockford, Illinois

EDSON I. GAYLORD Chairman
The Ingersoll Milling Machine Co. Rockford, Illinois

JAMES A. D. GEIER Chairman
Cincinnati Milacron Inc. Cincinnati, Ohio

THOMAS A. HOLMES Chrm. and Pres.
Ingersoll-Rand Company Woodcliff Lake, New Jersey

LEON C. HOLT, JR. Vice Chairman
Air Products and Chemicals, Inc. Allentown, Penn.

DESMOND F. HUDSON President
Northern Telecom Inc. Nashville, Tennessee

JAMES H. KEYES President
Johnson Controls, Inc. Milwaukee, Wisconsin

QUENTIN C. McKENNA Chrm. and Pres.
Kennametal Inc. Latrobe, Pennsylvania

DONALD R. MELVILLE Chairman
Norton Company Worcester, Massachusetts

GERALD B. MITCHELL Chairman
Dana Corporation Toledo, Ohio

JOHN C. MORLEY President
Reliance Electric Company Cleveland, Ohio

JOHN J. MURPHY Chrm. and Pres.
Dresser Industries, Inc. Dallas, Texas

J. TRACY O'ROURKE President
Allen-Bradley Company Milwaukee, Wisconsin

EARLE W. PITT Chairman
The Foxboro Company Foxboro, Massachusetts

WALTER F. RAAB Chairman
AMP Incorporated Harrisburg, Pennsylvania

PAUL G. SCHLOEMER President
Parker Hannifin Corporation Cleveland, Ohio

PETER L. SCOTT Chairman
Emhart Corporation Hartford, Connecticut

HENRY D. SHARPE, JR. Chairman
Brown & Sharpe Mfg. Co. N. Kingstown, Rhode Island

WARD SMITH Chrm. and Pres.
NACCO Industries, Inc. Cleveland, Ohio

RALPH Z. SORENSON Chrm. and Pres.
Barry Wright Corporation Newton Lower Falls, Mass.

NEIL A. SPRINGER Chrm. and Pres.
Navistar Int'l. Transportation Corp. Chicago, Ill.

JAMES R. STOVER Chairman
Eaton Corporation Cleveland, Ohio

DONALD TAYLOR Chairman
Inboard Inc. Brookfield, Wisconsin

RAYMOND C. TOWER President
FMC Corporation Chicago, Illinois

R. J. WEAN, JR. Chairman
Wean United, Inc. Pittsburgh, Pennsylvania

JAMES W. WILCOCK Chrm. and Pres.
PACE Industries Inc. Pittsburgh, Pennsylvania

Hand Delivery

James C. Treadway, Jr., Esq.
Chairman
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Dear Mr. Chairman and Members of the
Commission:

Report of the National Commission on Fraudulent Financial Reporting: Exposure Draft of April 1987

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views to the National Commission on Fraudulent Financial Reporting (NCFRR or "the Commission") with respect to NCFRR's Exposure Draft of its Findings, Conclusions, and Recommendations.

As stated by NCFRR, its mission since October 1985 has been to identify causal factors that can lead to fraudulent financial reporting, and identify steps to reduce its incidence. Further, NCFRR is a private-sector initiative, jointly sponsored and funded by the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Financial Executives Institute (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants (NAA).

In our view, NCFRR has done an exemplary job of examining the phenomenon of fraudulent financial reporting and then proposing remedies. However, we hasten to add that the implementation of all of NCFRR's proposed recommendations would lead to a quantum leap in private-sector and public-sector regulation of publicly held companies and independent accountants. Although many public companies and independent accountants are well along the way toward conforming with most NCFRR recommendations, the Commission has taken some steps that imply current and future overhead costs and red tape of an indeterminate amount.



MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES



We will attempt, with some of the surgical precision that NCFRR seems to have eschewed, to identify the marginal recommendations, and do so in a spirit of constructive criticism. As a preliminary matter, we offer a few observations of a general nature to put matters in perspective.

Diminishing Returns

First, the Commission must recognize that those involved in fraudulent financial reporting and audit failure are a very small fraction of the total population of individuals and organizations participating in financial reporting and audit. It follows, both intuitively and empirically, that efforts to lessen fraudulent financial reporting and audit failure at such a relatively low level of involvement will require sizable expenditures in exchange for any measurable gains. Moreover, the costs of additional effort will increase exponentially as the related gains increase at a diminishing rate. We point this out not to quarrel with any particular recommendation but to sensitize the Commission to the implicit costs and burdens of its entire set of proposals.

Commands and Exhortations

On an equally important matter, we believe that the key to reduced fraudulent financial reporting and reduced audit failure lies in ethical behavior by all persons involved in such processes. Persons so engaged must act with professionalism and recognize that they are in a position of trust. They must have a basic sense of fairness and obligation, and should not tolerate any lack of accountability. These attributes relate rather uniquely to personal and societal values, and we do not consider them very susceptible to additional "policing" (e.g., new rules or penalties) or symbolism (e.g., adopting codes of conduct). In other words, one can expect some measure of compliant response to commands and exhortations, but such remedies can entail high cost and diminishing returns.

Competition and Accountability

Another item we wish to raise at the outset is that audit failure can be reduced by steps taken to prepare independent accountants more thoroughly for the challenges of their vocation. Also, we agree that there should be a dismantling of impediments to successful accomplishment of the independent audit mission. On the other hand, we do not concur in the proposition that "competition" necessarily is inconsistent with accounting professionalism or independence. Nor do we believe that independent auditors should be relieved of responsibility for the quality of their work. To lessen competition and accountability would--in our opinion--ultimately weaken rather than strengthen independent accountants and their organizations. The Cohen Commission of a decade ago was criticized for its recommendations with respect to competition and potential legal liability, and we hope that NCFRR will be more circumspect.

99b

The Audit Committee and
Independent Accountants

We note that a number of the Commission's tentative recommendations are directed at the audit committee of the board of directors. In general, these proposals would increase the responsibility of audit committees by having them function as "screens" for various actions that would be taken by management, ranging from the routine issuance of interim reports to the engagement of the outside auditor to perform management advisory services. Short of objecting to these proposals, we would remind NCFRR that there are limits to what can be asked of independent directors without having them function as management itself or as "inside" directors (by whatever definition). Independent directors are not "on board" full time, and should not be given responsibilities and potential legal liabilities as if they were. A balance must be struck, or else the availability of qualified persons for audit committee duty will be lessened.

"Targeting"

Consistent with the foregoing, we have a number of observations concerning the tentative NCFRR recommendations. In our opinion, some should be eliminated and others should be moderated in order to give the final report a "targeted" appearance rather than that of a random cataloging of initiatives that might have some bearing on the reduction of fraudulent financial reporting and audit failure. No implication should be drawn as to the Institute's position about any NCFRR recommendations not raised in this statement for discussion.

Background

According to NCFRR, its recommendations, taken together, form a "balanced response" to fraudulent financial reporting. Further, NCFRR "cannot overemphasize" the importance of evaluating its recommendations in their totality in that no single one is meant to be separated from the rest. NCFRR further avers that its goal from the outset has been to develop recommendations that would be practical, reasonable in the circumstances, justified by the benefits to be achieved, and lend themselves to implementation "without undue burden." Among NCFRR's conclusions are the following:

- A company that raises funds from the public assumes an obligation of public trust and commensurate accountability.
- The independent public accountant who audits the financial statements of a public company also has a public obligation.
- The extensive financial reporting by public companies is the most critical component of the

disclosure that ensures the effective functioning of the capital and credit markets in the United States.

- The problem of fraudulent financial reporting cannot be quantified. However, the problem is serious; it can occur in any given company; and there is a realistic potential for reducing that risk.
- The responsibility for reliable financial reporting resides first and foremost at the corporate level.
- No one answer to the problem of fraudulent financial reporting exists.
- There are limits to the ability to prevent or detect fraud, no matter how much cost is incurred.
[Emphasis supplied.]

MAPI Comments on the NCFRR
Exposure Draft

The NCFRR Exposure Draft is organized with recommendations (1) for the public company; (2) for the independent public accountant; (3) for the SEC and others to improve the regulatory and legal environment; and (4) for education. We will take these up in the same order as listed.

Recommendations for
Public Companies

The NCFRR approach here is to improve the overall environment in which financial reporting occurs--including the "tone" set by top management--and to maximize the effectiveness of the functions within the company that are critical to the integrity of financial reporting.

Internal controls.--One NCFRR recommendation for the public company is to maintain internal controls that are adequate to "prevent" and detect fraudulent financial reporting.

As NCFRR undoubtedly is aware, the absolute "prevention" of fraudulent financial reporting is a goal, but should not necessarily be a measure of adequacy in given circumstances. No set of internal controls can prevent fraudulent financial reporting under all circumstances because collusion can circumvent controls and judgmental elements--not to mention human and machine error--always are at work. Our suggestion is that the word "prevent" be changed to "deter."

Codes of conduct.--NCFRR also states that public companies should develop and enforce written codes of corporate conduct. These codes should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting.

Further, NCFRR would recommend that a company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.

We do not object in principle to this, but the recommendation begs the question whether the review and reporting procedure should be regulated and formalized by some body in the public sector or private sector. In our opinion, the review and report procedure should not be regulated, but instead should be left "free form" so that individual audit committees can tailor their actions to the circumstances at hand.

We suggest that NCFRR take the position just mentioned when it prepares final recommendations. If the review and reporting practice is mandated by some regulatory or quasi-regulatory organization, formal procedures will follow and the report will emerge as "boilerplate."

Internal audit.--Another recommendation is that public companies maintain an "effective" (and "objective") internal audit function staffed with an "adequate" number of qualified personnel appropriate to the size and the nature of the company.

We do not know how to define an "effective" internal audit function staffed with an "adequate" number of qualified personnel, and rather suspect that the definition would be elusive, if attempted. Nor do we know how a public company can ensure that its internal audit function is "objective."

Is an internal audit function "ineffective" if its investigations produce little? Or is it not true that the "adequacy" of the number of qualified personnel is a function of the adequacy of the control systems and procedures in place? Is NCFRR concerned that internal audit functions be "objective" rather than "subjective," or is NCFRR implying something about the independent auditor's independence?

On this last-mentioned item, it appears to us from the text supporting the recommendation that "independence" is the intended test of "objectivity." Further, NCFRR refers specifically to a "chief internal auditor" having specific reporting relationships. The Commission even opines that the chief internal auditor should occupy a position of "high stature" within the organization, and that the chief executive officer should meet with him no less frequently than every quarter. We have no strong disagreement with the content of NCFRR's argument. However, the Commission seems to us to be "micro-managing" and the implications for regulatory follow-on concern us.

Audit committees.--Another NCFRR recommendation is that the board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.

Consistent with our feeling that governmental intrusion in affairs of accountancy should be sparing, we oppose this recommendation.

If audit committees must be mandated, we suggest that it remain a responsibility of the Self-Regulatory Organizations (SROs). As NCFRR is aware, the only SRO with a requirement of this sort to date is the New York Stock Exchange (NYSE). Further, we concur in the concept underlying the NYSE definition of "independent" director.

We note some ambivalence in the text supporting NCFRR's recommendation with respect to audit committees. Specifically, the Commission states that the mandating of audit committees is necessary but does not go far enough. Soon thereafter, NCFRR recommends that SEC be able to grant exceptions on a case-by-case basis because of the dearth of qualified persons to serve as independent directors, particularly in small, newly public companies. Ambivalence aside, the latter point is well taken.

In our opinion--to repeat--the fact of the matter is that the audit committee issue does not justify federal government intervention. Further, any companies that have instituted procedures and controls functionally equivalent to an audit committee should qualify for exception from any such requirement, even if imposed by an SRO.

Management advisory service.--NCFRR recommends that the audit committee approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

We understand the perception problem involved here, but also feel that the recommendation would be awkward in practice. For example, a company that uses a particular independent accountant for audit might like periodically to call one of that firm's tax partners to inquire about the applicability of rules and procedures in tax compliance that, in fact, are immaterial. Similarly, the client might wish to call the auditor to determine what is available in the way of new management information systems services. In yet another scenario, the client might wish to engage the auditor to review the systems and procedures of a particular department and make recommendations for improved efficiency.

Why should the audit committee be consulted in advance about an engagement that would not add commercial pressures to the audit examination and would not impair independence? We recommend that NCFRR revisit this recommendation and do what it can to "target" the advance-approval proposal.

Management reports.--In another recommendation, NCFRR states that all public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal controls, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

We note that this recommendation is more sweeping than the requirement under the Foreign Corrupt Practices Act (FCPA) in the sense that it covers all internal controls rather than "internal accounting controls." Also, it is less sweeping in that NCFRR inserts a materiality threshold whereas FCPA does not.

As in the case of SEC's aborted 1979 proposal on management reports, we believe that this one is aimed at establishing a requirement for a statement of compliance with the law, and would have the effect of identifying the existence of violations of the law. Consequently, the proposal may violate constitutional protections against self-incrimination, and should be reviewed by counsel to determine whether such an exposure exists.

In that connection, we note NCFRR's comment that a chief executive officer may want periodically to engage the company's independent public accountant to perform a complete examination of the company's system of internal accounting control.

Is NCFRR implying that the outside auditor might be engaged to conduct "operational" audit rather than accounting audit? To what extent would the auditor's "opinion" protect top management from charges of neglect associated with fraudulent financial reporting in which top management did not directly or indirectly engage? Would the outside auditor give a positive assurance or a negative assurance? If the latter, should NCFRR say something about the nature of the opinion to be rendered? These engagements are expensive, and those who perform them must bear some responsibility for the quality of the service they render.

New regulatory body.--NCFRR recommends that its sponsoring organizations establish a body to guide public companies on internal controls.

MAPI does not believe that public companies--already heavily regulated by public-sector and private-sector regulatory bodies--need another such agency to promulgate rules and regulations for the conduct of corporate affairs. As we already have stated, the "law of diminishing returns" is in effect.

One simply does not create a new regulatory body everytime there is a flurry of financial frauds or audit failures. Of all the recommendations made by NCFRR, this one is the most indiscriminate and extravagant, and, in our opinion, would devour scarce resources in exchange for minimal benefits.

Recommendations for the
Independent Public
Accountant

NCFRR states that the financial statements are first and foremost the responsibility of the management of the reporting entity.

999

Notwithstanding, the independent public accountant plays a crucial role in the financial reporting process.

NCFRR's proposals encompass (1) the design of audit scope and procedure to consider the potential for fraudulent financial reporting and detect the same; (2) the increased use of analytical review, plus timely review of quarterly financial data; (3) proposals to improve audit quality; (4) strengthened communications with users of the outside auditor's report; and (5) reorganization of the Auditing Standards Board (ASB) of AICPA.

Detection.--In somewhat more detail, NCFRR recommends that ASB revise its standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting; and (2) design tests to provide reasonable assurance of detection.

Our only comments with respect to this recommendation are that ASB--as NCFRR is well aware--has circulated for public comment 10 proposed new and/or amended auditing standards. The ASB action evidently was anticipatory of NCFRR's recommendation, and it might be useful to see what evolves from the ASB proceeding before arriving at a final recommendation.

The other item concerning us is simply to take care that any new or revised auditing standards are cost-effective. When the organization creating the standards is the organization of professionals expected to benefit from them, there is a presumed bias toward expanding the scope of responsibility while attempting to narrow the scope of potential legal liability. NCFRR should monitor very closely the costs and benefits of ASB initiatives and be sensitive to subtle shifts in the burden of legal liability.

Quarterly reports.--As already indicated, NCFRR recommends that SEC require independent public accountants to review quarterly financial data of public companies before release to the public.

In our opinion, this should remain voluntary with companies, and those that prefer a look-back review from year end should be permitted to continue with the same. We note with some interest that NCFRR conducted a study of year-end write-offs and found a concentration of the same in the fourth quarter. There is no mention, however, that a correlation appeared between companies with fourth quarter write-offs and look-back quarterly review. If there is no evidence from NCFRR's study to support a costly requirement of timely quarterly review, then the proposal strikes us as extravagant.

Concurring review.--On concurring (i.e., "second partner") reviews, NCFRR recommends revision of the AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report.

99h

The standards proposed by NCFRR for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.

Again, NCFRR is proposing to have extra layers of presumed protection against the risk of fraud. Clearly, the requirement to have a concurring review partner involved in the planning stage of the audit in addition to the final review stage could be expensive in relation to the anticipated benefits. We do not think that proposals of this sort should be advanced without field testing, surveying, and other procedures to ensure cost effectiveness.

If NCFRR were determined at any cost to squelch financial fraud and end audit failure, would the Commission next go to third partner or second firm review? Where would this dizzying spiral of costs end?

Standard report.--NCFRR recommends that the ASB revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.

Also, NCFRR recommends that ASB revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. Provision also would be made for explaining disagreements between the independent public accountant and management in their assessments of the internal accounting controls.

We have no objection to revising the standard report to make it more communicative. As NCFRR should be aware, the Cohen Commission recommended the same thing, but the project was dropped by a special task force of AICPA due to failure of the members of the task force to agree on the outcome.

Reorganize ASB.--NCFRR recommends that AICPA should reorganize the ASB to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not certified public accountants or are CPAs no longer in public practice.

For the most part, we concur in this recommendation. On the other hand, we think that continuing consideration should be given to establishing the ASB function more along lines of the Financial Accounting Standards Board.

Recommendations for the SEC
and Others To Improve the
Regulatory and Legal
Environment

NCFRR's proposals in this area involve additional SEC enforcement remedies, increased criminal prosecution, improved regulation of the public accounting profession, SEC's resources, financial institution regulatory agencies, enhanced enforcement by state boards of accountancy, and the current legal climate.

Fines.--NCFRR recommends that SEC have the authority to impose civil money penalties in administrative proceedings and to seek civil money penalties directly in an injunctive proceeding.

We would have found it useful if NCFRR had discussed the policy reason adopted earlier by Congress for not vesting SEC with authority to impose civil money penalties--other than in insider trading cases. As we understand the matter, SEC originally was given authority over disclosure statutes, and Congress believed that the free market would mete out sufficient punishment to those found to have filed improper or inadequate disclosures. We do not disagree with the original policy, but we also do not disagree with the proposition that a civil money penalty would add to the opprobrium. Obviously, there must be provision for administrative appeal and subsequent appeal to the judiciary.

Cease-and-desist orders.--NCFRR recommends that SEC have the authority to issue a cease-and-desist order when a securities law violation or an unsound financial reporting practice is found. This would be a milder remedy than a civil injunctive action because, for example, an injunction also might entail the statutory disqualification from serving as an officer or a director of an investment company.

We agree with this recommendation, subject to some modifications. First, the remedy would be helpful in cases in which SEC lacks sufficient evidence to demonstrate a reasonable likelihood of future violations, and in cases in which the SEC might hesitate to pursue injunctive relief because it would seem too harsh. Inasmuch as SEC might be using this remedy in marginal cases, we believe that the civil money penalty to be assessed and collected for each day during which the violation continues should be refundable, with interest, and SEC should be responsible for the defendant's court costs if the defendant eventually prevails on the issue.

Audit quality.--Among other proposals, NCFRR recommends that SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SEC Practice Section of AICPA's Division for CPA Firms. Also, NCFRR recommends that state boards of accountancy implement positive enforcement programs that periodically would review

the quality of services rendered by the independent public accountants they license.

We do not disagree with these proposals except as a matter of degree. Again, we have an instance of NCFRR's recommendations adding or reinforcing layers of regulation. The regulation, in turn, implies cost, administrative burden, and delay. We repeat that, in our opinion, NCFRR has not taken sufficient care to "target" these recommendations and has not been adequately sensitive to the nonproductive costs associated with its program.

Implications of liability.--NCFRR recommends that parties charged with responding to various tort reform initiatives consider the implications that the perceived liability crisis holds for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting.

NCFRR states that potential legal liabilities are jeopardizing the public accounting profession's (1) ability to attract and retain high-caliber professionals, and (2) future economic viability. Whether this is true or not--and we suspect that the position is overstated--we believe that tort reform must be considered in a much larger perspective than that of a single profession. Overall, we rather suspect that the thrust of NCFRR's recommendations would serve to "tilt" the relative potential legal liabilities toward management and away from independent accountants. Accordingly, we find somewhat incongruous the implicit message that independent accountants need special tort-reform protection in the public interest.

Corporate indemnification.--NCFRR recommends that SEC reconsider its long-standing position that the corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable.

We admit to having mixed feelings about this recommendation. With the separation of ownership and management that exists in publicly held companies, directors must bear responsibility for acting on the shareholders' behalf. Creating shareholder value is management's primary responsibility, and we view with skepticism proposals that either work to disenfranchise shareholders or compromise the institutional mechanisms that focus management attention on the shareholders' interests. The trend of changes in state corporation laws noted by NCFRR could continue and accelerate as states compete to provide a "friendly corporate domicile." If this were to happen, federal preemption might come under consideration, and we question whether Congress would be solicitous of board members' concerns about indemnification.

The other side of the coin is that there, in fact, is a serious shortage of officers' and directors' liability coverage. Whether worries about personal liability have reached the point of jeopardizing the essential contribution of independent directors is a

matter on which we would prefer to reserve judgment. If all of NCFRR's recommendations were to be adopted, there would be a sizable shift of responsibility to audit committee members, such that they could be expected to demand both more compensation and additional liability protection. This would put the corporation in a difficult position if it could not acquire satisfactory liability insurance and if it were not permitted by state law to offer broad indemnification.

In other words, we recognize the dilemma, and also see exposures in the proposed remedy. We might add that NCFRR's "Audit Committee Good Practice Guidelines" are very demanding. When it is considered that some publicly held companies--generally smaller ones--still do not have audit committees but instead perform audit committee functions while sitting as the full board of directors, one wonders whether there should not be more flexibility in the recommendations to account for and accommodate to the lesser resources of smaller firms.

Recommendations for Education

NCFRR offers a number of recommendations pertaining to (1) the role of education in preparing participants in the financial reporting system; (2) business and accounting curricula; (3) five-year accounting programs; (4) professional certification examinations; (5) continuing professional education; and (6) educational initiatives by public companies. The stated idea behind the proposals is to help to make present and future participants in the financial reporting process better informed about fraudulent financial reporting and better prepared to prevent, detect, and deter it.

We concur in all of the recommendations presented by NCFRR for education.

Concluding Comment

In conclusion, we repeat that the Commission has, in our opinion, done a masterful job with a difficult subject. The document containing the final recommendations will chart a course and set an agenda that should lead to a lesser incidence of fraudulent financial reporting and audit failure. Our only wish is that the recommendations for the public company, the independent public accountant, and the legal environment be "tightened up" and "targeted." In accomplishing this, we hope that the Commission will demonstrate more sensitivity about cost-effectiveness, and justify each of its proposals with an analysis of costs and benefits.

Finally, NCFRR should be aware that its final report, if not moderated, could be the engine for a regulatory juggernaut that could do more harm than good. Financial fraud and audit failure--however grievous when they occur--are relatively infrequent phenomena, and the measures taken to arrest them should be flexible, conservative, and exception-oriented.

We hope these views will be of use to NCFRR. If the Commission or its staff would like to discuss the matter further, please do not hesitate to call us at 202/331-8430.

Very truly yours,

Ken McInnan
P r e s i d e n t

100



**Washington
Gas**

Washington Gas Light Company
1100 H Street, N.W.
Washington, D.C. 20080

Frederic M. Kline
Controller

June 30, 1987

Mr. James C. Treadway, Jr., Chairman
National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Dear Mr. Treadway:

Washington Gas Light Company (Washington Gas) appreciates the opportunity to express its views on the Exposure Draft: Report of the National Commission on Fraudulent Financial Reporting. Washington Gas is a natural gas company engaged primarily in the purchase, distribution and sale of natural gas at retail in the metropolitan area of Washington, D. C., which includes the District of Columbia and adjoining areas in the states of Maryland and Virginia, with over \$700 million in annual revenues.

Washington Gas supports the Commission in its undertaking to identify causal factors that can lead to fraudulent financial reporting and develop recommendations to minimize its occurrence. We generally agree with the recommendations made by the Commission, which embrace all participants in the financial reporting process. Our primary interest, however, lies in the recommendations for the public company.

Washington Gas agrees with most of the recommendations proffered by the Commission on ways public companies can prevent and detect fraudulent financial reporting. The recommendations reaffirm our belief that the responsibility for reliable financial reports rests primarily with top management in that management sets the tone and establishes the financial reporting environment. We also agree with the recommendations which emphasize the importance of adequate internal controls, an effective and objective internal audit function and the role of the audit committee in overseeing the integrity of the company's financial reporting. Indeed, Washington Gas has in place many of the concepts embodied within the recommendations.

We are concerned, however, with the Commission's apparent disregard of the significance of the cost of its recommendations. The Commission weakly attempts to address the cost/benefit relationship in Section VI of Chapter One with the rather broad conclusion that "the long-term benefits of these recommendations - enhanced corporate control and ethical business conduct - outweigh the costs of implementing them." It is not apparent from the report that any specific studies were performed with regards to, for instance, quarterly reviews by the audit committee of the financial statements or the

160b

mandatory inclusion in annual reports of a management letter regarding the adequacy of the entire internal control system. A pilot program could be undertaken to quantify the costs associated with the Commission's recommendations, thus providing a more concrete foundation for evaluating the cost/benefit relationship.

Washington Gas appreciates the opportunity to respond to the Exposure Draft: Report of the National Commission on Fraudulent Financial Reporting.

Frank M. Kline



**Rockwell
International**

**Corporate Offices
600 Grant Street
Pittsburgh, PA 15219**

June 30, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

We are pleased to respond to the Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting.

Generally, we support the recommendations outlined in the Commission's Exposure Draft. In fact, procedures at Rockwell International already are in accordance with the majority of the Commission's recommendations. However, there is one proposal which we believe should be reconsidered with a view to its deletion.

We strongly oppose the Commission's recommendation that audit committees approve quarterly financial results prior to public release. The Commission's specific recommendations regarding the audit committee's role in preventing and detecting fraudulent financial reporting are contained in Section IV of Chapter Two. The basic thrust of these recommendations is that the audit committee should be comprised solely of independent directors who can provide informed, vigilant, and effective oversight of the the company's financial reporting process and internal controls. We fully endorse this independent oversight role for the audit committee. Implementation of these specific recommendations would provide that (1) the audit committee satisfies itself as to the adequacy of internal controls, (2) the audit committee is kept informed of important developments that affect quarterly financial results and (3) the external auditors review the quarterly financial results. We believe these procedures properly safeguard the integrity of the financial reporting process.

We have, however, two significant concerns regarding the proposal to have audit committees approve quarterly financial results prior to public release. First, the approval requirement would make audit committees an integral component of the financial reporting process thereby detracting from their ability to serve as independent overseers of the financial reporting process. Second, it will significantly impede the timely release of quarterly financial results and thereby deprive investors of prompt availability of important financial data without any compensating benefit.

The financial reporting process is the primary responsibility of management and should not be shared by a committee of the board of directors. Instead the board of directors should retain an oversight responsibility which acts as a check and balance to management's primary responsibility. In our view, joint responsibility will damage, both in appearance and in fact, the audit committee's crucial oversight role without discernibly improving the quality of quarterly financial information.

National Commission on
Fraudulent Financial Reporting
June 30, 1987
Page 2

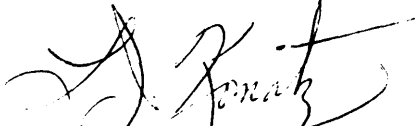
Moreover, timely release of financial results will be impossible, or at best substantially delayed, if outside directors must approve quarterly financial results prior to public release. This inevitable delay also will result in added risks of premature leaks of the preliminary data.

We have reviewed this letter with the Chairman of the Audit Committee of Rockwell International's Board of Directors. He has asked us to state his full concurrence in the views expressed herein and to emphasize his view that an audit committee has a primary oversight responsibility rather than a participatory responsibility in the financial reporting process.

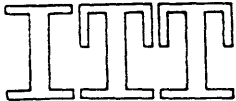
We urge you to delete this requirement from the final report of the Commission.

Respectfully submitted,

ROCKWELL INTERNATIONAL CORPORATION



L. J. Komatz, Controller



ITT Corporation

World Headquarters

*320 Park Avenue
New York, N.Y. 10022
Telephone (212) 752-6000*

*Raymond H. Alleman
Senior Vice President
and Comptroller*

June 30, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006

SUBJECT: Exposure Draft - Findings, Conclusions, and
Recommendations of the Commission

Members of the Commission:

I participated in the preparation of the comment letter on the Exposure Draft that is being submitted by the Management Accounting Practices Committee of the National Association of Accountants, and I endorse the points made in that letter.

The publicity that surrounds the issue of fraudulent reporting has encouraged overreactions in proposals by some groups, including some of the proposals by the Auditing Standards Board that the Commission plans to consider for its final report. The Commission's Exposure Draft, however, generally reflects resistance to the pressures for overreactions; the tone of the Draft is constructive. The Commission appropriately placed emphasis on the importance of the "tone at the top" of companies, and on the creation of systems and attitudes within companies that facilitate proper practices. This emphasis goes to the heart of whether or not problems will begin. Consistent with that, the recommendations that the SEC's enforcement powers be enhanced are logical and appropriate responses to wrong doings that occur.

Several of the Commission's recommendations, however, go too deeply into specific details of how responsibilities are to be carried out:

1. Commission Recommendation:

Annual reports should include a letter from the chairman of the audit committee and a report of management.

102a

Comment - These types of disclosures tend to become boiler-plate that dilutes rather than fulfills responsibilities. The risk disclosures required by the SEC under Item 503(c) of Regulation S-K is an instructive analogy. That risk disclosure is intended to arm the investor with knowledge of the specific risks of an enterprise. In practice, the disclosures generally are broadly similar, from company to company, with little help for the reader on the specific situation. In the case of managements', directors', and audit committees' responsibilities for financial statements and supporting systems, the responsibilities exist, they are well known to users of statements, and they are inescapable for managements and directors. Letters in annual reports will not enhance these responsibilities, and, in fact, may dilute them.

2. Commission Recommendation:

When a company changes independent public accountants, the company should be required to disclose publicly the material accounting or auditing issues discussed.

Comment: Considerable rigidity will be introduced in accountant-client discussions. Disclosure of "issues" is too vague an instruction in the light of the range of topics that are discussed each year in even the most idyllic accountant-client relationships. Further, legitimate discussions could be misinterpreted if disclosed in such circumstances, causing inappropriate harm to the participants. The present SEC requirements with respect to disclosure of disagreements between accountant and client are sufficient and appropriate.

3. Commission Recommendation:

The audit committee should approve interim financial statements prior to public release.

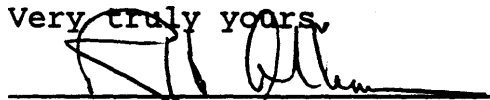
Comment: ITT involves the entire Board in review of quarterly and full-year projections and developments in each Board meeting. With this background, the Directors then review the financial statements and associated management messages. This is one of a number of appropriate approaches, none of which is superior to another. We see no reason for a particular approach to be imposed on all U.S. public companies.

The Commission is urged to make a distinction between assignments of responsibilities and specific direction on the method of fulfilling these responsibilities, and to adopt recommendations only in the former.

The Exposure Draft noted that the Commission will consider the Auditing Standards Board's (ASB) proposed standards that address issues related to fraudulent reporting. The ASB went too far in its proposal on Errors and Irregularities. The ASB assigned to public accountants the impossible (but costly) task of detecting errors and irregularities. The ASB's proposal is contrasted with the Commission's more balanced direction "... to design tests to provide reasonable assurance of detection." The direction in the Commission's Exposure Draft should be retained.

In summary, the Commission's Exposure Draft represents a solid response to the problem of fraudulent financial reporting. Although there have been relatively few cases of fraudulent reporting, their existence has cast doubt on general reporting practices. Many of the Commission's recommendations represent steps already followed by most large companies, but it is appropriate that these steps be made standard practice for all public companies. In a few areas, the Exposure Draft went too far into the specifics of how responsibilities are to be discharged; the document would be better without such specifics.

Very truly yours,

A handwritten signature in dark ink, appearing to be "R. Allen", written over a horizontal line.

cc: Management Accounting Practices Committee of the National Association of Accountants



PENNZOIL PLACE • P. O. BOX 2967 • HOUSTON, TEXAS 77252-2967 • (713) 546-8974

June 30, 1987

N. J. LUKE
Group Vice President
Corporate Finance
and Accounting

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Gentlemen:

Pennzoil Company is pleased to submit written comments on the Exposure Draft of the Report of the National Commission on Fraudulent Financial Reporting. We agree with the Commission that many of the recommendations are not new and have in fact already been considered and implemented in many public companies, including Pennzoil Company. Pennzoil endorses the Commission's efforts to identify those factors that can lead to fraudulent financial reporting and concurs with the spirit of the Commission's recommendations, if not the letter in all cases.

We agree wholeheartedly with the tone and intent of the Commission's recommendations. We would ask that the Commission reconsider the recommendation that the audit committee be required to approve quarterly financial results before they are released to the public. While it is agreed that the board of directors has ultimate responsibility for accurate and timely reporting of financial condition and operating results, Pennzoil feels that it is impractical for the audit committee to approve quarterly financial results before release. We believe that arranging for pre-release review of financial results by the audit committee will result in delays and require more detailed involvement by independent public accountants, perhaps even requiring audits of quarterly results. There is little flexibility in the schedule for preparation and release of quarterly financial results. In many instances audit committees are comprised of directors who must travel from distant locations and whose schedules would make difficult a meaningful pre-release review of a company's quarterly results each and every quarter. It is possible that a requirement for a pre-release review each quarter might make it more difficult to attract qualified audit committee members. Each company has its own culture and as a practical matter has its own procedures established for the review of information released to the public (including quarterly financial results).

103a

Pennzoil follows the practice of having the independent accountants review financial results each quarter and furnish a letter covering that review to the board of directors. While this review is not a full audit, it is an extension of the independent public accountants' review of the company's financial condition and results of operations for the total year on which an opinion is expressed. We feel this procedure, along with appropriate internal controls, and such other specific oversight as the audit committee may decide to exercise in particular cases, is adequate to prevent release of fraudulent and misleading financial information. It is our opinion the audit committee should satisfy themselves that adequate controls are in place to ensure the desired results. These procedures in some cases may indeed include a review by the audit committee. In other cases internal controls and procedures agreed to by the audit committee will be adequate and any additional benefits of a review before financial results are released will be outweighed by the costs.

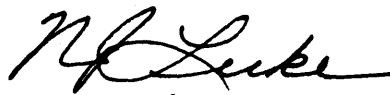
As a practical matter it is impossible to assemble a set of rules or guidelines which are infallible. Ethics in the business environment cannot be legislated in an effort to eliminate fraudulent financial reporting. The managements of Corporate America can only provide an environment which is conducive to ethical business conduct and select those managers who will best perform in that environment. Adequate internal controls are only a part of that environment or culture.

In general the Commission's recommendations for public companies form an excellent foundation on which all companies can build a system of checks and balances. Each company's corporate environment, reporting structure, and personnel should be considered in determining the appropriate degree and form of implementation.

In any case, each company and its board should be allowed to establish review procedures applicable to the release of quarterly earnings. These procedures should be suited to a company's corporate culture, competitive and business environment and industry segment. We do not feel that a set of inflexible rules and mandates will necessarily improve the incidence of fraudulent reporting.

Thank you for the opportunity to reply to the Commission's Exposure Draft on Fraudulent Financial Reporting.

Very truly yours,



N. J. Luke

104



C. Perry Colwell
Corporate Vice President and Controller

Room 29-3142
550 Madison Avenue
New York, NY 10022-3297
212 605-5200

June 30, 1987

Mr. G. Dewey Arnold, Executive Director
National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20026

Dear Mr. Arnold,

AT&T appreciates this opportunity to respond to the April 1987 Exposure Draft, Report of the National Commission on Fraudulent Financial Reporting and commends the Commission for its efforts. For the most part, we agree that the Commission's recommendations are practical, reasonable in the circumstances, justified by the benefits to be achieved, and can be implemented without undue burden. The Commission has done an excellent job in identifying the causes of fraudulent financial reporting and developing comprehensive recommendations to mitigate (but not prevent) it from occurring, as well as enhance the probability of detection should it occur. Given the complexities of fraud and the dynamic environments that most companies operate within, we urge the Commission to reenforce the understanding that these, or any cost effective recommendations have limitations with respect to the ability to prevent and detect fraud.

We concur with the need to evaluate the Commission's recommendations in their totality, since it is the overall effect that will achieve the desired improvement, rather than any single recommendation or group of recommendations standing alone. However, we do have concerns regarding certain recommendations as discussed below.

Chapter Two: Recommendations for the Public Company

1. Recommendation: For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

Response: The ED does not discuss possible steps that management can take to discharge this obligation. The recommendation can be interpreted to require a significant documentation effort similar to what many companies did in response to the Foreign Corrupt Practices Act. Although some flexibility in the recommendation is desirable, we urge the Commission to clarify the expectations of Management in the implementation of the recommendation.

- 2. Recommendation: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

Response: The concept of reasonable assurance should be incorporated into the recommendation to recognize the cost/benefit considerations in developing an internal control system.

- 3. Recommendation: Public companies should ensure that their internal audit functions are objective.

Response: While we agree that "public companies should ensure that their internal audit functions are objective (independent)," having the chief internal auditor report to the CEO does not achieve that goal and, in fact, may well be counterproductive. The report gives the impression (p 34) that anything less than direct administrative reporting to the CEO is second best. We believe objectivity and independence are achieved not so much in the administrative reporting relationship as in other aspects of organizational positioning and relationships. For example, it is very important (as the Commission report states) that the chief internal auditor have direct and unrestricted access to both the CEO and the audit committee. To ensure the reality of this access, periodic private meetings with both should be held, either as a matter of course or as the occasion demands. Furthermore, the chief internal auditor, and in fact all internal auditors, should have unrestricted access to all operations, records, personnel, and physical properties which they consider relevant in the performance of their audits. It should be clear to all managers and other employees that they are expected to be candid with internal auditors, and to make available any material or information requested in the course of the audit. In other words, it is these functional relationships and unrestricted access, rather than administrative reporting lines, which make objectivity and independence a reality. We therefore believe

that the Commission should not attempt to prescribe the reporting relationship for the chief internal auditor, but rather provide that an informed audit committee and management determine the appropriate organizational placement.

- 4. Recommendation: The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

Response: This recommendation is unnecessarily restrictive and may inhibit management's responsiveness in cases when prompt action is required. An "after-the-fact" review by the audit committee would provide for adequate review and evaluation of issues concerning independence of public accountants.

In addition, it should be recognized that the circumstances, as well as time constraints, affecting each company and audit committee are different. Consequently, the audit committee and management should determine the best approach to satisfying their responsibilities.

- 5. Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

Response: We disagree with the inclusion of a letter signed by the chairman of the audit committee in the annual report. We believe that with the acceptance of the other recommendations by the Commission, the activities and responsibilities of the audit committee will become known, and within the larger public companies, probably standardized. The audit committee chairman's letter acknowledging these responsibilities will add minimal value and will become "boilerplate" wording in the report. Additionally, activities and responsibilities of the audit committee can be effectively incorporated into the Report of Management or in other sections of the Annual Report should such disclosure be deemed appropriate.

- 6. Recommendation: When a public company changes independent accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

Response: We believe that existing SEC disclosure requirements which cover "... any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his report to the subject matter of the disagreement ..." are adequate. There are many reasons for changing auditors unrelated to accounting and auditing issues. We do not believe it would serve any useful purpose to require disclosures which may not be related to the reasons for a change.

- 7. Recommendation: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

Response: We do not believe that, as a general rule, the audit committee should be required to review or approve quarterly financial results prior to their release. It is not practical to have the audit committee do this and at the same time release such results on a timely basis. The logistics involved in furnishing quarterly results to the audit committee and the time spent by the committee in exercising its oversight responsibility, would unnecessarily delay the timeliness of their release and, therefore, inhibit the flow of information to the public.

- 8. Recommendation: The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

Response: The establishment of a body to guide the development of internal controls will impose an unnecessary cost on sponsoring organizations when there already exists adequate guidelines for internal controls. Major public accounting firms and effective internal auditing functions have very good internal control review checklists that can be utilized by management to ensure that proper internal controls exist. In addition, organizations such as the AICPA and Institute of Internal Auditors provide guidance on internal control matters. Given the competency requirements of management, work performed by independent accountants and internal auditors, as well as enhanced communication with audit committees, we believe that a standard body for internal controls is unnecessary. The key factor in the concept of internal control is management's determination to put controls in effect.

Chapter Three: Recommendations for the Independent Public Accountant

- 1. Recommendation: The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.

Response: AT&T's concerns with respect to auditing standard exposure drafts relating to this recommendation have been incorporated into responses by the Financial Executives Institute forwarded directly to the Auditing Standards Board.

- 2. Recommendation: The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.

Response: The Commission recognizes that in some circumstances an adequately designed system of internal accounting controls is not justified. However, including a description of the extent of review and evaluation of internal accounting controls in the auditor's standard report may result in unfair and misleading interpretations of companies in which controls were not tested or partially tested. We question whether financial statement users are better equipped to appreciate this distinction than the broader concern of the Commission. We disagree with introducing this technical complexity in the standard report.

Sincerely,



C. P. Colwell



FINANCIAL EXECUTIVES
INSTITUTE

Robert W. Moore
President

June 30, 1987

Mr. G. Dewey Arnold, Executive Director
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Mr. Arnold:

Financial Executives Institute's (FEI) appreciates this opportunity to respond to the April 1987 Exposure Draft Report of the National Commission on Fraudulent Financial Reporting.

FEI commends the Commission for its efforts. The Commission has done an excellent job in identifying the causes of fraudulent financial reporting and developing a comprehensive set of recommendations designed to prevent it from occurring and to detect it when it does occur. For the most part, we agree that the Commission's recommendations are practical, reasonable in the circumstances, justified by the benefits to be achieved, and would lend themselves to implementation without undue burden.

We also agree with the Commission that the existing financial reporting system functions remarkably well, and organizations charged with overseeing the process of setting standards by and large do an admirable job of appropriately balancing the public interest and the burdens regulation imposes on business. We strongly believe that the private-sector institutions in place, supplemented by the Commission's recommendations, are the appropriate and most effective method of meeting the public's needs. Separate legislation -- other than as may be needed to implement certain of the Commission's recommendations -- is not needed and would potentially impose additional costs on U.S. industry that could not be justified by the related benefits and would weaken the U.S. competitive position in world markets.

We recognize the need to evaluate the Commission's recommendations in their totality, since it is the overall effect that will achieve the desired improvement, rather than any single recommendation or group of recommendations standing alone. In this regard, we have an overriding concern that the

105a

Mr. G. Dewey Arnold, Executive Director
June 30, 1987
Page 2

report, in its totality, would impose an unrealistic burden on members of audit committees. We note, for example, the comment in Appendix K on page 43 that, "An audit committee consisting of independent directors is the primary vehicle that the board of directors uses to discharge its responsibility with respect to the company's financial reporting." We do not believe (a) this is a valid representation of the situation that exists at most companies today, and (b) it is a reasonable expectation for the future unless the role of audit committees is radically altered from an oversight to a participatory role. We, therefore, urge the Commission to reconsider the overall tone of its approach in this regard. Our comments in response to specific recommendations that bear on this issue contain a number of suggestions.

We also have some concerns and fine-tuning suggestions about various other recommendations. Our responses to specific recommendations are set forth.

Sincerely,


Robert W. Moore

RWM/af

cc: Chairman James C. Treadway
Commissioners William M. Batten
William S. Kanaga
Hugh L. Marsh, Jr.
Thomas I. Storrs
Donald H. Trautlein

FINANCIAL EXECUTIVES INSTITUTE
STATEMENT OF POSITION

RESPONSE TO THE APRIL 1987 EXPOSURE DRAFT REPORT OF THE
NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING

June 30, 1987

CHAPTER TWO: RECOMMENDATIONS FOR THE PUBLIC COMPANY

Recommendation: For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

Response: The text accompanying this recommendation states that the process of assessing risk is an ongoing procedure rather than a separate project. Also, management judgment dictates the extent and nature of the assessment. The Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting in Appendix H (page 158) reinforce this by stating that assessing the risk does not necessitate a separate effort.

Despite this, an organized effort of some kind seems indicated with participation by "individuals at all levels of the company," and supervised by "top-level corporate management, such as the CEO and the CFO." We are concerned that this could be interpreted to require a massive documentation effort on the part of U.S. industry, along the lines of that which many companies undertook to demonstrate compliance with the provisions of the Foreign Corrupt Practice Act. Accordingly, we request that the Commission clarify its intent that this recommendation is not intended to impose a burdensome documentation effort.

In conjunction with this issue, we believe the Good Practice Guidelines in Appendix H provide helpful insights regarding matters that should be taken into consideration in identifying, understanding, and assessing the factors that may cause a company's financial statements to be fraudulently misstated. We compliment the Commission on developing these guidelines. Again, however, we believe it should be further stressed that it is not the Commission's intent to require comprehensive documentation of the issues covered in the Guidelines.

Recommendation: Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

Response: Just as the concept of "reasonable assurance" is an integral part of the Foreign Corrupt Practices Act, it is essential that "reasonable assurance" be explicitly included in the above recommendation to avoid any possible misunderstanding -- just as it is included in the first recommendation in

105c
June 30, 1987

Chapter 3. Clearly, the cost of 100% prevention would be prohibitive. Comments in other areas of the Report, such as those on page 24 under the heading "Need for Cost-Effective Responses," indicate that the Commission is sensitive to this concern. We urge that this same sensitivity be reflected in the recommendation by changing it to read "Public companies should maintain internal controls that are adequate to reasonably assure the prevention and detection of fraudulent financial reporting."

Recommendation: Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. A company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.

Response: We concur with the Commission's views regarding the need for a written code of corporate conduct. However, review of compliance with the code of conduct should be an integral part of the audit committee's ongoing oversight process. The last sentence of the recommendation could be interpreted to imply that such review is somehow separate from the financial reporting process and internal control system. We suggest this be clarified by prefacing the last sentence with the words "As part of its ongoing assessment of the effectiveness of internal controls, a company's audit committee" Also we suggest the word "annually" be changed to "periodically," since the need for review may be more or less frequent than annually.

Recommendation: Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.

Response: The text accompanying this recommendation indicates that the chief accounting officer is directly responsible for the financial statements and should be held responsible for fraudulent financial reporting. This statement implies that the CAO has control and knowledge of all factors that influence fraudulent financial reporting, which is contrary to fact and inconsistent with other aspects of the draft report. For example, there can be cases where the CEO, the CFO, and/or other top executives, acting independently or in collusion, can adopt fraudulent financial reporting practices that, at least for a period of time, might not be detected by the CAO. Clearly, the CAO cannot be held responsible for such practices when he is not in the information stream and has no knowledge of them. We believe the Commission's Report must recognize this and, in addition, must enhance the ability of the CAO to meet his responsibilities in all possible ways. These would include, for example, participation in audit committee meetings and a requirement that management must discuss with the audit committee the reasons for changes in a CAO.

105d

June 30, 1987

Recommendation: Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.

Response: The text accompanying this recommendation indicates that the company should set forth in writing the scope of responsibilities of the internal audit function, and the audit committee should adopt this document formally. We support properly defining the scope of the internal audit function, but we strongly believe that this is a management function. Formal adoption by the audit committee takes that committee beyond an oversight role and effectively makes the committee a part of operating management. We believe the Commission must be very careful in defining the role and activities of the audit committee to assure that it retains its independent oversight status.

The text also refers to the IIA's Quality Assurance Standard that calls for external (peer) reviews of the internal audit function. We do not agree that this is an appropriate way to enhance the effectiveness of the internal audit function, because it would potentially expose confidential corporate information to competitors, suppliers, and customers. The close working relationship of the external and internal auditors effectively provides an ongoing oversight of the internal audit function. However, if the Commission believes a more formal review is required, we suggest that the internal audit function be reviewed periodically by an independent accounting firm -- either the company's current firm or another firm. In addition, we strongly object to any imposed frequency of such reviews, as well as the concept of review by internal auditors from other companies.

Recommendation: Public companies should ensure that their internal audit functions are objective.

Response: While we certainly agree that "public companies should ensure that their internal audit functions are objective [independent]"; having the chief internal auditor report to the CEO does not achieve that goal and, in fact, may well be counterproductive. The report gives the impression (page 34) that anything less than direct administrative reporting to the CEO is second best. We believe objectivity and independence are achieved not so much in the administrative reporting relationship as in other aspects of organizational positioning and relationships. For example, it is very important (as the Commission report states) that the chief internal auditor have direct and unrestricted access to both the CEO and the audit committee. To ensure the reality of this access, periodic private meetings with both should be held, either as a matter of course or as the occasion demands. Furthermore, the chief internal auditor, and in fact all internal auditors, should have unrestricted access to all operations, records, personnel, and physical properties which they consider relevant in the performance of their audits.

165e

June 30, 1987

It should be clear to all managers and other employees that they are expected to be candid with internal auditors, and to make available any material or information requested in the course of the audit. In other words, it is these functional relationships and unrestricted access, rather than administrative reporting lines, which make objectivity and independence a reality. We, therefore, believe that the Commission should not attempt to prescribe the reporting relationship for the chief internal auditor, but rather require that an informed audit committee assume responsibility for reviewing and approving the reporting relationship.

The text under this recommendation indicates that, "The chief internal auditor should be an experienced audit professional" We disagree that this is a necessary prerequisite. Many large companies are well staffed with highly trained and experienced internal auditors, who bring to bear the necessary expertise to perform the function. The chief internal auditor should bring to the function desirable leadership attributes, broad experience (not necessarily in auditing, per se), personal integrity, and the ability to work effectively with fellow senior officers. Previous auditing experience is not essential, however, and the overall effectiveness of the function could be diminished if this were an absolute requirement. Companies must have the latitude to staff such a position based on what they deem to be the appropriate qualifications.

Recommendation: Internal auditors should consider the implications of their nonfinancial audit findings for the company's financial statements.

Response: We support this recommendation.

Recommendation: Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.

Response: We support this recommendation in principle. However, a number of member companies are concerned about required participation of internal auditors in the consolidation process, because they view this as unnecessary duplication of effort.

Recommendation: The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.

Response: While we strongly support the establishment of audit committees of the board by all public companies, we recognize that there are important questions relating to the availability of qualified independent directors to serve on these committees, particularly with respect to smaller companies.

1058

June 30, 1987

Recommendation: Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.

Response: We support this recommendation. We are including separately comments on Audit Committee Good Practice Guidelines.

Recommendation: All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it at least annually, and modify it as necessary.

Response: We support this recommendation, except that we suggest the word "annually" be changed to "periodically." Annual review would not be necessary in many cases.

Recommendation: Audit committees should have adequate resources and authority to discharge their responsibilities.

Response: We support this recommendation.

Recommendation: The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.

Response: We support this recommendation.

Recommendation: The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

Response: This recommendation is unnecessarily restrictive and could inhibit management flexibility in cases where quick action is needed. For example, a situation could arise in an acquisition or divestiture where it was essential to engage the company's independent accountants for some type of management advisory services on a time-critical basis which would not be logistically possible to clear with the audit committee in advance. In any event, we believe the substance of this recommendation is implicitly covered by the provisions of the previous recommendation. If the Commission believes this matter requires separate attention, we suggest it indicate that the audit committee should perform an after-the-fact review of such management advisory services rather than approving them in advance. We believe it is important to note that none of the Commission's studies indicated any actual case where independence was compromised by the performance of such services. This response also pertains to the comparable recommendation in Appendix K.

1859
June 30, 1987

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

Response: We strongly support the concept of a management report, and we are commenting separately on the Good Practice Guidelines for Management's Report. However, we are very concerned with the suggestion on page 41 that CEOs should periodically engage independent accountants to examine and opine on the company's system of internal accounting control. FEI studies conducted in conjunction with SEC proposals related to the Foreign Corrupt Practices Act indicated that such examinations could increase audit fees some 40% to 50% on average. The proposal was dropped because it was not believed such costs were justified by the benefits. Most companies that maintain a strong, effective internal audit function continue to believe that further examination of internal accounting controls by independent auditors cannot be cost justified. We, therefore, request that the inference be removed that all companies have their outside auditors periodically conduct such an examination other than as required to permit the auditors to render an opinion on the financial statements.

Recommendation: All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

Response: Many companies now include in the financial section of their annual report a letter from management and a letter from the independent accountant. Requiring a letter from the chairman of the audit committee would result in unnecessary redundancies. The value of the audit committee lies in the oversight that it provides, not its publicity value. Acknowledgment of the existence and activity level of such a committee should suffice to satisfy the information needs of most users.

The above response also pertains to Appendix M. However, the substantive information in Appendix M should be considered for inclusion in the Management Report (Appendix L).

Recommendation: Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.

105M

June 30, 1987

Response: We do not believe this recommendation in its present form is warranted. We strongly agree with the textual comment that "Management has, and should have, the prerogative to seek second opinions." This is certainly true; in fact in some cases, management may even be considered to have a responsibility to seek a second opinion, as, for example, in situations where it is dealing with the novel application of accounting principles to important transactions. The responsibility of management to advise the audit committee should be limited to cases where the second opinion differed from that of its independent public accountant, and the company relied on the second opinion to support an accounting treatment that the independent accountants originally disagreed with. Anything beyond this encroaches on management's responsibilities and unnecessarily overburdens the audit committee with irrelevant detail.

Recommendation: When a public company changes independent accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

Response: During the course of an audit, companies and their auditors routinely discuss material accounting and auditing issues. In the accounting area, for example, accounting changes resulting from new FASB Standards usually require discussion with auditors as regards the most appropriate application for the company. In the vast majority of cases, such situations are resolved to the mutual satisfaction of the company and its auditors without major disagreement. In the auditing area, routine discussions are required to ensure that there is appropriate coordination between internal and outside auditors to provide complete audit coverage and avoid duplication of effort.

We do not believe it would serve any useful purpose to require companies to disclose such discussions when they change auditors. There are many valid reasons why companies might seek to change auditors, including merely wanting a "fresh look" by a different accounting firm. The proposed disclosure would imply a sort of stigma attached to any change in auditors and would add to information overload. It would inhibit companies from changing auditors for legitimate reasons other than disagreement on an accounting or auditing issue.

We believe that existing SEC disclosure requirements which cover "... any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his report to the subject matter of the disagreement ..." are quite adequate.

Recommendation: Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

1657

June 30, 1987

Response: We do not believe that the audit committee should be required to review or approve quarterly financial results prior to their release. It is not practical to have the audit committee do this and at the same time release such results on a timely basis. The logistics involved in furnishing quarterly results to the audit committee, and the time spent by the committee in exercising its oversight responsibility and in approving such results could and often would unnecessarily delay the timeliness of their release and, therefore, inhibit the flow of information to the public. This would represent, on balance, a step backward from current practice.

For example, we believe most audit committees meet on the same day as the company's board of directors (or the day before or after). If earnings are not ready for release until several days after such meeting, there could be a two or three week delay until there was another audit committee meeting. Any such delays would be unfair to the company's stockholders, would increase the likelihood of leaks, and would expose company management unnecessarily to charges of inappropriate use of insider information.

Moreover, we believe this activity would cloud the distinction between the audit committee's oversight responsibility and participation in the financial reporting process, which is clearly a management responsibility.

We believe the recommendation in Chapter Three to have the independent accountant review quarterly results should suffice to enhance the integrity of the quarterly financial reporting process.

Recommendation: The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

Response: There may be a need for more guidance in this area along the lines suggested in the Exposure Draft. However, we believe the appropriate body to provide this guidance would be the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board (ASB), if it is reconstituted along the lines recommended by the Commission on pages 55-57. The reconstituted ASB would include broad-based representation from the several constituencies involved and would provide the appropriate forum in which to deliberate these issues. It would obviate the need for a new body, which would be more costly to establish and maintain.

CHAPTER THREE: RECOMMENDATIONS FOR THE INDEPENDENT PUBLIC ACCOUNTANT

Recommendation: The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such

105)

June 30, 1987

reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.

Response: Financial Executives Institute's (FEI) Committee on Corporate Reporting (CCR) has previously commented to the Auditing Standards Board on its Proposed Statement on Auditing Standards, "The Auditor's Responsibility to Detect and Report Errors and Irregularities." Since this recommendation addresses the substance of that proposal, we are attaching as Exhibit A CCR's June 11, 1987 letter to the Auditing Standards Board in response to this recommendation.

Recommendation: The Auditing Standards Board should establish standards to require independent public accountants to perform analytical review procedures in all audit engagements and should provide improved guidance on the appropriate use of these procedures.

Response: We support this recommendation. CCR has previously commented to the Auditing Standards Board on its Proposed Statement on Auditing Standards, "Analytical Procedures," and we are attaching as Exhibit B a copy of CCR's June 11, 1987 letter.

Recommendation: The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.

Response: We support this recommendation and are aware that many companies follow some form of auditor quarterly review. There may be some question as to whether, in current practice, companies and their auditors are following all of the procedures outlined in the recommendation. Nevertheless, we believe the operative phrase is "enhance the reliability of quarterly data," and we believe that timely reviews will serve to focus attention on the interpretation of transactions or events which can best be dealt with either before or just after they occur.

If full review procedures are to be adopted; it may not be feasible, in many cases, to complete this review before release of financial data to the public. In many cases, the press release contains only summary income statement information, and a full set of financial statements has not been completed. We believe it will be more practical and uniform to call for completion of the review procedures before filing of the quarterly Form 10-Q. This would allow an additional two to four weeks beyond conventional press release dates.

105K

June 30, 1987

Frequently, review procedures begin before the end of the quarter and proceed throughout the period to the filing of the Form 10-Q. Generally, sufficient review can be accomplished to accommodate the public release within two to three weeks of the close of the quarter. The balance of the review procedures can then be completed before filing of the Form 10-Q.

Recommendation: The AICPA's SEC Practice Section should strengthen its peer review program by increasing review of audit engagements involving public company clients new to a firm. For each office selected for peer review, the first audit of all such new clients should be reviewed.

Response: We support this recommendation.

Recommendation: The AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.

Response: We have no position on this recommendation. We do note, however, that the requirement for the concurring review partner to have familiarity with the client's industry could possibly impose a hardship on some smaller public accounting firms.

Recommendation: Public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality.

Response: In the textual discussion on page 51, it is indicated that tight reporting deadlines can pressure auditors to stop pursuing identified problems prematurely. We take exception to this observation because we do not think it is true in practice and may be misleading to lay readers. Proper planning for the audit should take such matters into consideration and provide for appropriate follow-up and resolution.

We also take exception to the discussion under the heading of "Broad accounting principles" on page 52. We do not think that there are identifiable links between choice of accounting methods and fraudulent financial reporting. It seems to us that this paragraph weakens the impact of the report and undermines the independence of the FASB and their prodigious efforts over many years to narrow acceptable practices.

Recommendation: The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.

and

Recommendation: The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.

Response: CCR has previously commented to the Auditing Standards Board on its Proposed Statement on Auditing Standards, "The Auditor's Standard Report." Since these recommendations address the substance of that proposal, we are attaching as Exhibit C CCR's June 11, 1987 letter to the Auditing Standards Board in response to this recommendation.

Recommendation: The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice.

Response: We strongly support this recommendation and related suggestions for implementation. Industry participation on the Financial Accounting Standards Board, on the Emerging Issues Task Force, and on the Accounting Standards Executive Committee has provided a needed and pragmatic balance. We believe that it would have the same salutary effect on the Auditing Standards Board. While such assignments are time consuming and demanding in other ways, we feel certain that competent and experienced individuals can be found outside of the practicing profession to contribute to the ASB process.

CHAPTER FOUR: RECOMMENDATIONS FOR THE SEC AND OTHERS TO IMPROVE THE REGULATORY AND LEGAL ENVIRONMENT

Recommendation: The SEC should have the authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding.

105M

June 30, 1987

Response: We support this recommendation; however, recent substantive criminal penalties and sizable liability judgments in several highly publicized cases of fraudulent financial reporting seem to suggest that the SEC could achieve similar results by utilizing its existing powers more effectively. If the SEC were to obtain express fining authority, the amount of the fine and the related violation should be clearly defined. Also to be considered is the establishment of procedures for appeal, so that such broad authority will not lead to the inequitable levy of fines. Finally, your Commission should consider whether there should be consistency and linkage between the SEC's authority to impose fines and those of other regulatory bodies (e.g., the Commodity Futures Trading Commission and other self-regulatory organizations).

Recommendation: The SEC should have the authority to issue a cease and desist order when a securities law violation or an unsound financial reporting practice is found.

Response: We support this recommendation; however, we believe that the SEC should also more fully explore the range of options currently available to it to prevent unsound financial reporting practices from harming the public. For example, the SEC could refuse to accept filings by companies previously associated with unsound financial reporting practices until they have satisfactorily redressed all known past wrongdoings and answered all legitimate complaints. Also, the term "unsound financial practices" is too vague. It requires a definition, or at least examples, to be properly understood. We, therefore, recommend that the final report elaborate on what is meant by "unsound financial practices" so that the SEC will not have difficulty incorporating it into their rules and enforcing it. We also believe that if cease and desist authority is given to the SEC, the nature of the activities within its scope and the circumstances in which it can be used should be clearly defined.

Recommendation: The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent reporting from future service in that capacity in a public company.

Response: We support this recommendation, but we believe it essential that the guidelines for imposing a bar or suspension and the requisite due process proceedings be clearly stated by the SEC.

Recommendation: Criminal prosecution of fraudulent financial reporting cases should become a higher priority. The SEC should conduct an affirmative program to promote increased criminal prosecution of fraudulent financial reporting cases by educating and assisting government officials with criminal prosecution powers.

105 N
June 30, 1987

Response: We support this recommendation to make criminal prosecution of fraudulent financial reporting cases a higher priority. Fraudulent financial reporting would lead to substantial social and economic costs. On the one hand, the public may suffer direct financial losses in relying on the integrity of the reported financial information. On the other hand, there is a far more serious consequence when the public and business community lose confidence in the marketplace because of the presence of or the potential for fraudulent and manipulative practices. The SEC should be encouraged to follow through on its enforcement efforts with every attempt to bring criminal proceedings against offenders, such as transmitting evidence to the United States Attorney General, assisting the Department of Justice and the U.S. Attorneys to the maximum extent in cases that ought to be litigated, providing access to investigative files, and providing personnel to assist in presenting these cases before the courts.

Recommendation: The SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SECPS of the AICPA's Division for CPA Firms.

Response: We believe that the SEC should encourage public accounting firms to be members of a professional organization that has peer review and independent oversight functions; however, since most major public accounting firms are already members, this recommendation will primarily affect smaller firms. The typical requirements and quality assurance systems for large firms, such as in-house continuing professional education programs, rotation of partners, involvement of second partners, and internal inspection programs, etc., may not be cost beneficial for smaller firms unless modified or administered differently. Therefore, while we fully endorse the idea of requiring uniform quality assurance standards for all public accounting firms that audit public companies, including peer review, mandatory membership in a professional organization should not be required.

Recommendation: The SEC should take enforcement action when a public accounting firm fails to remedy deficiencies cited by the public accounting profession's quality assurance program.

Response: We support this recommendation. Your Commission should recommend that the SEC formalize its procedures for reviewing and monitoring public accounting firms' failure to remedy the deficiencies cited by the public accounting profession's quality assurance program. Similar to requiring auditors to report their disagreements with their clients to the SEC, it would be constructive for the SEC to require accounting firms performing peer review of other firms to report to the SEC major quality deficiencies which have not

1050

FEI Statement of Position
Response to the April 1987 Exposure Draft Report
of the National Commission on Fraudulent Financial Reporting
Page 14

June 30, 1987

been remedied. In addition, the SEC should specify the range of enforcement actions which it may impose in such circumstances, such as censure and moratorium on acceptance of new public clients, in order to deter public accounting firms from ignoring severe deficiencies.

Recommendation: The SEC must be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting.

Response: We support this recommendation.

Recommendation: The financial institution regulatory agencies should provide for the exchange of information between the regulatory examiner and the independent public accountant.

Response: We support this recommendation. However, although there are benefits from enhanced communication, we believe that the scope of the information to be shared should be clearly defined and some parameters should be established for this higher level of cooperation and disclosure. We believe that this must be done in a way which would not jeopardize existing client-auditor confidentiality, generate potential conflict of interest, or impair the effectiveness of the independent auditor. For example, without explicit guidelines, the recommendation could be read to include the auditor's working papers. This could lead to precedents being set for the exchange of information resulting in the loss of confidentiality of the auditor's working papers. By being more specific, such as recommending an exchange of "material findings" or "summary reports," communication between the regulatory examiners and the independent public accountant could be enhanced without the adverse effects.

Recommendation: The SEC should reconsider its long-standing position that the corporate indemnification of directors for liabilities that arise under the Securities Act of 1933 is against public policy and, therefore, unenforceable.

Response: We strongly support this recommendation and believe that this recommendation should be emphasized and raised as a priority issue. The inability to obtain directors' insurance would severely undermine public companies' success in recruiting and retaining qualified outside directors. We agree with the Commission that outside directors are necessary components of an effective audit committee, which, in turn, is a key to preventing fraudulent financial reporting. Accordingly, we believe strongly that the SEC's long-standing position regarding corporate indemnification of directors should be reconsidered because it would not be beneficial to the prevention of fraudulent financial reporting.

1058

CHAPTER FIVE: RECOMMENDATIONS FOR EDUCATION

The recommendations in this chapter appear reasonable. However, we are not in a position to express a view as to the viability of their implementation.

APPENDIX K - AUDIT COMMITTEE GOOD PRACTICE GUIDELINES

Issue: The post audit good practice guidelines suggest that the audit committee should determine the open years on federal income tax returns and whether there are any significant items that have been or might be disputed by the IRS, and inquire as to the status of the related tax reserves.

Response: We believe that the suggested measure extends beyond the oversight responsibility of the audit committee. It is the responsibility of management to review the status of income tax returns and related accruals. Furthermore, the measure appears redundant to the suggested inquiry as to the existence and substance of significant accounting accruals, reserves, or estimates made by management that had a material impact on the financial statements. We do not believe that the oversight function should extend to individual accruals or issues that do not have a material effect on the financial statements. We recognize that the measures enumerated are not prescribed by the Commission, but, nonetheless, believe that many companies and/or their audit committees will view the practices as obligatory.

Issue: The post audit good practice guidelines include a requirement for the audit committee to request an explanation from financial management and the independent public accountant of changes in accounting standards or rules that have an effect on the financial statements.

Response: We support the recommendation for audit committee inquiry as to accounting changes but believe it should be limited to those which are likely to have a material effect on the financial statements.

Issue: The post-audit good practice guidelines recommend that the audit committee review the MD&A section of the annual report with management and ask the extent to which the independent public accountant reviewed the MD&A section. It is further suggested that the audit committee inquire of the independent public accountant as to the consistency of other information in the annual report with that reflected in the financial statements.

1056

June 30, 1987

Response: We believe that the audit committee review with management, as contained in the first recommendation of this section, is sufficient as to the MD&A section of the annual report. The independent public accountant would presumably be present during this discussion. Further, the independent public accountant is already obliged under general accepted auditing standards to read other information in annual reports to determine whether there are material inconsistencies or misstatements of fact, as compared with the information presented in the financial statements. Once again, we are concerned that this recommendation will be interpreted literally and that a new de facto auditing standard will emerge in practice.

APPENDIX L - GOOD PRACTICE GUIDELINES FOR MANAGEMENT'S REPORT

Issue: The illustrated management report is somewhat redundant, potentially confusing in certain respects and negative as to tone in other respects.

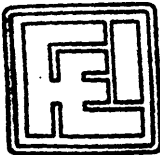
Response: We believe that the representations regarding the integrity and reliability of financial statements in the illustrative report are sufficient to support the conclusion that they are not materially misleading as a result of intentional or reckless conduct (fraudulent financial reporting, as defined by the Commission). Accordingly, the phrase "and are not misstated due to material fraud or error" is redundant (and unnecessarily negative) and should be deleted. The phrase "and the prevention and detection of fraudulent financial reporting" is similarly redundant and should also be deleted.

The statement in the second paragraph that "management believes all representations made to XYZ Co. during its audit were valid and appropriate" is potentially confusing to the uninformed reader, is somewhat redundant to the preceding sentence and is of questionable value in the overall context of a management report of this nature.

Issue: The illustrated management report includes the signature of the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO). Chapter 2 (page 40, paragraph 5) indicates that the management report should be signed by the CEO and the Chief Accounting Officer (CAO).

Response: We agree with the Commission's observation (page 32) that, depending on the size and nature of a company, the role of the CAO may be vested with the controller or CFO. We suggest that the illustrative report contain the proviso for signatures of the CEO and CAO.

Enclosures



FINANCIAL EXECUTIVES INSTITUTE
10 MADISON AVE. BOX 1938, MORRISTOWN, N. J. 07960 201 898-4800

JOSEPH A. SCIARRINO
VICE PRESIDENT
AND TECHNICAL DIRECTOR
(201) 898-4807

June 11, 1987

American Institute of Certified Public Accountants
Auditing Standards Division
1211 Avenue of the Americas
New York, New York 10109-0004

File 2545
Proposed Statement on
Auditing Standards:
The Auditor's Responsibility
to Detect and Report Errors
and Irregularities

Gentlemen:

The Committee on Corporate Reporting (CCR) of Financial Executives Institute appreciates the opportunity to comment on the AICPA's Proposed Statement on Auditing Standards (SAS), "The Auditor's Responsibility to Detect and Report Errors and Irregularities." We support the overall thrust of the proposed SAS, including expanding the auditor's responsibility to reasonably ensure that errors and irregularities are detected, and to inform the audit committee about irregularities. However, we object to several significant aspects of its content upon which we wish to comment.

Expectation of Auditing Standard

In paragraph 5, the proposal states, "An examination conducted in accordance with generally accepted auditing standards should be designed to detect material misstatements that affect the financial statements." Paragraph 6 appears to reduce the auditor's responsibility since it states, "Because of the characteristics of certain irregularities, particularly those involving forgery and collusion, a properly designed and executed examination may not detect a material irregularity." To provide consistency and clarify what users may expect from auditors, we suggest that the Board modify paragraph 5 to state, "An examination conducted in accordance with generally accepted auditing standards should be designed to provide reasonable assurance that

AICPA Auditing Standards Board
File 2545
Page 2

June 11, 1987

material misstatements that affect the financial statements will be detected" (underlining indicates change). This revision is also consistent with the statement in paragraph 7, "Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee."

Paragraph 22 states, "The auditor's first concern is to reach a conclusion on whether the financial statements, taken as a whole, are materially misstated." We agree that whether the financial statements are "materially misstated" is a matter of concern to the auditor. However, we believe the auditor's first and broadest concern is whether the financial statements are "fairly presented." We suggest that the statement in paragraph 22 be revised to reflect a more positive approach. Also, the revised statement should be moved to the beginning of paragraph 5 to emphasize that the detection of a material misstatement is not, in and of itself, the goal of the audit.

Taking all the above into consideration, the first two sentences of paragraph 5 would read as follows: "The auditor's first concern is whether the financial statements, taken as a whole, are fairly presented. Consequently, an examination conducted in accordance with generally accepted auditing standards should be designed to provide reasonable assurance that material misstatements that affect the financial statements will be detected."

Definition of Errors and Irregularities

Paragraph 3 states that "Irregularities include fraudulent financial reporting undertaken to render misleading financial statements, sometimes called management fraud, and misappropriation of assets, sometimes called employee fraud or defalcations." We recognize that the term "management fraud" is used in SAS 16; however, as a synonym for fraudulent financial reporting, it is both inaccurate and unnecessarily provocative. Indeed, in discussing fraudulent financial reporting, the April 1987 Exposure Draft Report of the National Commission of Fraudulent Financial Reporting properly acknowledges on page 2, paragraph 1, that "Company employees at any level may be involved, from top to middle management to lower-level personnel." Accordingly, we believe that the term "management fraud" should be eliminated. Similarly, the term "employee fraud" could be interpreted to exclude higher-level personnel. This would be equally inaccurate, because top and middle management could be involved in misappropriation of assets or defalcations. As a result, we suggest that the above sentence in paragraph 3 be modified to read as follows:

Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, and misappropriations of assets, sometimes called defalcations.

AICPA Auditing Standards Board
File 2545
Page 3

June 11, 1987

We agree with the statement in paragraph 2, footnote 2 that "Errors do not include the effect of accounting processes employed for convenience." However, we believe that the statement is equally applicable to irregularities. For example, a company may intentionally and systematically not recognize a liability (and the related offsetting entry) for goods shipped FOB shipping point but not received if the cost of accounting for these transactions exceeds the benefit, and the simplified accounting does not materially affect the financial statements. Accordingly, we recommend that a similar footnote be added to paragraph 3. We suggest the following which incorporates the discussion above:

Irregularities do not include the effect of accounting processes employed for convenience, such as not recognizing a liability (and the related offsetting entry) in conformity with generally accepted accounting principles for goods shipped FOB shipping point but not received, if the cost of accounting for these transactions exceeds the benefit and the simplified accounting does not materially affect the financial statements.

This footnote would be referenced to the word "disclosure," the last word in paragraph 3.

The Auditor's Responsibility to Detect Errors and Irregularities

We are concerned that the proposal does not discuss the cost/benefit considerations involved in an audit. Although the proposal discusses materiality of errors and irregularities, it remains unclear about the amount of effort that must be expended by the auditor to detect such amounts. As a result, the amount of effort required to comply with the proposal will be subject to different interpretations, some of which may result in excessive audit costs. Accordingly, we believe that the proposal should explicitly recognize that audits of financial statements are subject to cost/benefit considerations. We believe that the proposal should recognize, as does SAS 16, that the cost of an audit should bear a reasonable relationship to the benefits expected to be derived.

Consideration of the Possibility of Material Misstatements in Audit Planning

Paragraph 10 discusses the effect that the size, complexity, and ownership characteristics have on the factors that influence audit risk. The example relating to a large public company cites several factors that the auditor should consider. We believe the list should be extended to include the effectiveness of the internal auditing function, which would be consistent with the SAS 9 requirement that the auditor considers the work of ". . . internal auditors in determining the nature, timing, and extent of his own auditing procedures."

1050

AICPA Auditing Standards Board
File 2545
Page 4

June 11, 1987

Evaluation of Audit Test Results

Paragraph 21 states that if the auditor suspects an irregularity, he must pursue several audit steps to determine whether the financial statements could be materially misstated. We are concerned about the implications of this requirement, because in many cases, additional audit procedures may not be necessary. This might be true, for example, when management has already investigated the irregularity and resolved the situation, when low-level employees are involved, or when amounts are clearly immaterial. We suggest that paragraph 21 be modified to reflect this concern. The advice in paragraph 23b seems much more appropriate -- to be satisfied that the implications of the suspected irregularity have been adequately considered.

The Effect of Irregularities on the Audit Report

Paragraph 26 requires auditors to disclaim an opinion on the financial statements and communicate their audit findings in writing to the board of directors when the scope of the audit has been restricted so that the auditor is precluded from applying the necessary procedures to detect irregularities.

We appreciate the intent of this proposal to limit such reporting procedures to circumstances where the auditor is prevented from applying audit procedures significant to the auditor's ability to express an opinion on the financial statements. However, we are concerned that the term "necessary" does not sufficiently clarify this intent and consequently may be misinterpreted. It is conceivable that a disclaimer could result when the omitted procedure relates only to a small or insignificant part of the audit even though the auditor is able to complete the majority of the audit work. In this circumstance, we do not believe that a disclaimer and the related reporting to the board of directors is appropriate. Rendering a disclaimer on the financial statements in this circumstance is also inconsistent with current auditing standards. Accordingly, we urge the Board to modify paragraph 26 to permit the auditor to exercise judgment in deciding whether sufficient information has been obtained to render an opinion on the financial statements.

Paragraph 26 also discusses the auditor's response when there is uncertainty about whether possible irregularities may materially affect the financial statements. In this circumstance, auditors are also required to disclaim an opinion and indicate their audit findings to the board of directors. We believe that auditors should be permitted to exercise judgment and, depending on the circumstances, either qualify the opinion or disclaim an opinion, as now permitted by SAS 16.

105V

AICPA Auditing Standards Board
File 2545
Page 5

June 11, 1987

Communications Concerning Errors or Irregularities

We are also concerned about the term "clearly inconsequential" in paragraph 28 which is used as a threshold above which reporting of irregularities to the audit committee is required. This term would seem to require the reporting of many minor items to the audit committee. Also, we are not aware that the term is used, or otherwise defined, in generally accepted auditing standards or in generally accepted accounting principles. We believe that it would be preferable to limit the items being reported to the audit committee to "material" irregularities. However, we recognize that in certain instances, an irregularity which is not material to the financial statements, taken as a whole; may be of sufficient significance to warrant reporting to the audit committee. This might be the case, for example, when senior management is involved.

Consistency Among Auditing Standards

Paragraph 8 refers to factors that influence audit risk. The term "audit risk" is defined in SAS 47. We suggest that the SAS 47 definition and appropriate cross-reference be shown in a footnote.

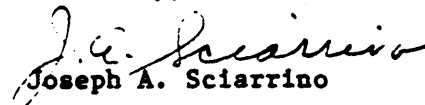
Paragraph 8 also indicates that the auditor should obtain an understanding of the control environment. We believe there is some overlap here with the guidance in the proposed SAS on "The Auditor's Responsibility for Assessing Control Risk." To avoid confusion, we believe these two SAS's should use consistent terminology and avoid duplication to the extent possible. We would expect the broader guidance to appear in the "Control Risk" SAS.

In the interest of consistency with the proposed SAS on "Communications With Audit Committees or Others With Equivalent Authority and Responsibility," we suggest that the first sentence of paragraph 27 be modified to read (addition underlined), "the auditor's responsibility to communicate the implications of audit adjustments . . ."

In addition, paragraph 27 requires that immaterial and waived audit adjustments be reported to the audit committee. Consistent with our response to the SAS on "Audit Committee Communications," we suggest that the reporting to the audit committee be limited to material amounts.

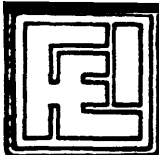
The CCR would be pleased to discuss any questions you may have on its views.

Sincerely,


Joseph A. Sciarrino

JAS/af

cc: Messrs. Jerry D. Sullivan, Chairman of the Auditing Standards Division
A. Clarence Sampson, Securities and Exchange Commission
Linda C. Quinn, Securities and Exchange Commission
National Commission on Fraudulent Financial Reporting



FINANCIAL EXECUTIVES INSTITUTE

10 MADISON AVE. BOX 1838, MORRISTOWN, N. J. 07960 201 899-4800

Exhibit B - Page 1 of 1

105W

JOSEPH A. SCIARRINO
VICE PRESIDENT
AND TECHNICAL DIRECTOR
(201) 899-4807

June 11, 1987

American Institute of Certified Public Accountants
Auditing Standards Division
1211 Avenue of the Americas
New York, New York 10109-0004

File 2125
Proposed Statement on
Auditing Standards:
Analytical Procedures

Gentlemen:

The Committee on Corporate Reporting (CCR) of Financial Executives Institute (FEI) welcomes the opportunity to express its views on the Exposure Draft (ED) on the Proposed Statement on Auditing Standards (SAS), "Analytical Procedures."

The CCR strongly supports the proposal in the ED that analytical procedures "should be applied in all examinations of financial statements made in accordance with generally accepted auditing standards." FEI's position on the "Financial Fraud Detection and Disclosure Act of 1986" addressed this issue and supported the related conclusions of the National Commission on Fraudulent Financial Reporting. FEI's position paper stated that "Greater reliance should be placed on analytical review procedures." Accordingly, we commend the Board for requiring, in the ED, the use of these procedures on all engagements and believe the incremental costs of performing such procedures will be minimal in relation to the potential benefits derived.

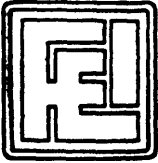
Sincerely,


Joseph A. Sciarrino

JAS/af

cc: Mr. Jerry D. Sullivan, Chairman of the Auditing Standards Board
National Commission on Fraudulent Financial Reporting

105X



FINANCIAL EXECUTIVES INSTITUTE
10 MADISON AVE., BOX 1938, MORRISTOWN, N. J. 07960 201 898-4800

JOSEPH A. SCIARRINO
VICE PRESIDENT
AND TECHNICAL DIRECTOR
(201) 898-4607

June 11, 1987

American Institute of Certified Public Accountants
Auditing Standards Division
1211 Avenue of the Americas
New York, New York 10109-0004

File 2347A
Proposed Statement on
Auditing Standards:
The Auditor's Standard Report

Gentlemen:

The Committee on Corporate Reporting (CCR) of Financial Executives Institute is pleased to respond to the AICPA Exposure Draft (ED), Proposed Statement on Auditing Standards, "The Auditor's Standard Report."

We concur with the Board's statement that the purpose of the auditor's standard report is to communicate the nature of the auditor's work and the auditor's conclusions about the financial statements. However, we do not agree that the present auditor's report contains overly technical language warranting such drastic revision. Contrary to the perception of the Board, we believe the present wording of the auditor's report has gained understanding, acceptance and support by its universe of users. To us, an element by element comparison of the present wording to that of the proposal suggest that adoption of this proposal will do little or nothing to close the "expectation gap."

The underlying purpose of the auditor's report is to relay audit findings. While a restatement of the auditor's role may offer some assurance to the auditor that he has fulfilled his responsibilities, we do not believe users will perceive any additional assurance. To us, the "expectation gap" is one of perception. Thus, no matter how commendable the motives of this proposed change in wording, closure will not be effected by a mere change in communication but must be responded to by efforts to raise the quality of audit work.

1054

AICPA Auditing Standards Board
File 2347A
Page 2

June 11, 1987

Consistent with the above, we do not agree with the following proposed changes:

- a. (l.c.) A statement that the financial statements are the representations of management.

The present codification of generally accepted auditing standards correctly states that ". . . Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things help assure the production of proper financial statements." Historically, this responsibility has been clearly outlined in many companies' Report of Management which is located in the Annual Report adjacent to the independent auditor's report.

If not withstanding the above, it is decided to retain this or a similar statement, we urge that the last sentence of the introductory paragraph end with the more appropriate phrase; are the responsibility of X Company's management. Furthermore, we believe this statement should only be required when it is not presented in the Report of Management.

- b. Independent Auditor's Report, Scope Paragraph.

We have serious problems with the proposed scope paragraph. Our problems arise when the auditor's report diverts from a statement of auditing standards to a partial statement of auditing procedures. Of necessity, the auditor's report cannot enumerate all of the significant procedures performed.

We do not accept the principle that auditing standards require that an audit be designed ". . . to evaluate whether the financial statements are materially misstated (intentionally or unintentionally)." This is an unduly negative way to describe the audit process. Moreover, we view the evaluation of whether financial statements are materially misstated, albeit an important audit objective, to be only one of several objectives. We do not believe the scope paragraph is an appropriate place for a partial listing of auditing procedures that the auditor must accomplish in order to achieve reasonable assurance. Again, this problem appears to arise because of the mixture of auditing procedures with auditing standards, and in the process, we believe the audit design suggests a strong similarity to transaction audits. Otherwise, how can the auditor possibly discern intention? In any event, we oppose the negative and provocative description of the intent of an audit.

1052-1

AICPA Auditing Standards Board
File 2347A
Page 3

June 11, 1987

Because of our concern, we urge the Board to reconsider the entire scope paragraph. The presently worded scope has served the profession well and we recommend its continuance; "our audit was conducted in accordance with generally accepted auditing standards and, accordingly, included such other auditing procedures as we considered necessary in the circumstances."

c. Independent Auditor's Report, Opinion Paragraph.

We also have serious problems with the proposed opinion paragraph which appears to be the most radical change to the present standard report. The draft proposes to state that ". . .the financial statements referred to above are, in all material respects, fairly presented" That is significantly different than the present opinion which states that ". . .the statements referred to above present fairly the financial position of (name of company) at December 31, 19XX and the results of operations, and changes in financial position for the year then ended" We do not object to the addition of the words "in all material respects" to inform the reader that the opinion does not attest to the absolute accuracy of the financial statements. What bothers us is the elimination of a truly meaningful opinion about the financial statements. Each statement has a particular purpose, i.e., to portray financial position/condition, results of operations or changes in financial position. Either the financial statements give a fair view of a company's financial condition and results of operations, i.e., "present fairly" or they do not, and that's what the auditors should be opining on - not that the financial statements themselves are fairly presented.

We urge the Board to reconsider the opinion paragraph.

- d. Finally, we oppose the proposed modification to auditor's standard reports regarding uncertainties. Specifically, we question replacing "subject to" opinions with "modified" (add on) language in regard to general uncertainties. To do so, discounts the importance users have placed on "subject to" as a traditional flag alerting users that, although the financials are fairly presented, unquantified material uncertainties exist that could have a material impact on the company's financial statements. Our primary concern regarding this proposed revision is that it will either worsen the "expectation gap" by causing more clean opinions in troubled

152-0

AICPA Auditing Standards Board
File 2347A
Page 4

June 11, 1987

situations or "more likely" result in a proliferation of modifications to the extent that mechanical boilerplate language will be the general rule rather than the exception. We consider either alternative to be unacceptable and recommend retention of the "subject to" standard.

Having stated a strong preference for the present wording of the auditor's report, if the Board is determined to change such wording then we find the following proposed changes in basic elements of the revised auditor's report to be acceptable:

- a. The report should be titled, and the title should include the word independent.
- b. The report should include a statement that the financial statements were audited.
- c. The report should include a statement that the audit was performed in accordance with generally accepted auditing standards.
- d. The report should include a statement that the auditor believes the procedures performed were appropriate in the circumstances to express the opinion presented.

We appreciate the opportunity to comment on these important matters and would be glad to discuss our response with you at your convenience.

Sincerely,


Joseph A. Sciarrino

JAS:af

cc: Messrs. Jerry D. Sullivan, Chairman of the Auditing Standards Board
A. Clarence Sampson, Securities and Exchange Commission
Ms. Linda C. Quinn, Securities and Exchange Commission
National Commission on Fraudulent Financial Reporting

June 30, 1987

Mr. G. Dewey Arnold
Executive Director
National Commission on
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

RE: Exposure Draft - Report of the National Commission on
Fraudulent Financial Reporting (the "Commission")

Dear Mr. Arnold:

Kimberly-Clark Corporation is responding to the above subject exposure draft dated April 1987, hereinafter referred to as the "Treadway Report" or the "Report."

Overall View

In general, we support the efforts of the Commission and endorse the majority of the recommendations contained in the Treadway Report. Further, we have already "adopted" or shortly plan to "adopt" many of the recommendations in the Report. We do, however, have the following comments, questions and observations to offer on certain recommendations, accompanying text or Good Practice Guidelines contained in the Report.

Chapter Two - Recommendations for the Public Company

Recommendation 1. For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.

1060

Mr. Arnold
June 30, 1987
Page 2

We agree with the intent of the recommendation and the accompanying Good Practice Guidelines. We further support the statements in the text accompanying the recommendation that ... "the process of assessing risk of fraudulent financial reporting, which is part of an ongoing operating procedure rather than a separate management project, requires exercise of judgment and creativity. Top management's judgment dictates the extent and the nature of the assessment appropriate to a particular company." The Good Practice Guidelines also state that "... assessing the risk of fraudulent financial reporting does not necessitate a separate effort..."

We are concerned, however, that the Commission may be anticipating some type of an organized documentation effort of "fraudulent financial reporting risk" based on other language of the exposure draft, with participation by "individuals at all levels of the company," supervised by "top-level corporate management, such as the CEO and the CFO." This language could be interpreted to suggest a massive documentation effort, similar to that undertaken to comply with the Foreign Corrupt Practice Act (FCPA). We do not believe such a documentation effort will be cost effective for many enterprises. Accordingly, we suggest the Commission state that it does not intend that implementation of the recommendation result in a comprehensive and exhaustive documentation effort.

Recommendation 2. Public companies should maintain internal controls that are adequate to prevent and detect fraudulent financial reporting.

The Commission acknowledges in the accompanying text that the FCPA embraced the concept of "reasonable assurance" with respect to the operation of a company's system of internal accounting control, but the wording of the actual recommendation fails to contain the "reasonable assurance" qualification. It is our experience that construction of any internal control system adequate to prevent all errors or irregularities is either impossible or prohibitively expensive.

In order to avoid any possible misunderstanding, we urge the Commission to modify its recommendation similar to the following:

Public companies should maintain internal controls that are adequate to provide reasonable assurance that fraudulent financial reporting will be prevented and/or detected.

106 b

Mr. Arnold
June 30, 1987
Page 3

Recommendation 3. Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. A company's audit committee should review compliance with the code annually, including compliance by top management, and report thereon to the board of directors.

We support the recommendation.

Recommendation 4. Public companies should maintain accounting functions that can effectively meet their financial reporting obligations.

We support the recommendation.

Recommendation 5. Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and nature of the company.

Although we support the recommendation, we believe the accompanying text should be modified to eliminate the requirement that the "... audit committee should adopt this document ... (i.e., the written scope of responsibilities for the internal audit function)." In our view, adoption of such a document is a legitimate function of management. In contrast, adoption of the document by the audit committee would extend the committee beyond its oversight role and into a management role.

The text also endorses the Institute of Internal Auditors (IIA) Quality Assurance Standard for periodic external (peer) reviews of the internal audit function. We strongly disagree with the recommendation. We do not believe it is good practice to permit access of non-Kimberly-Clark internal auditors to our internal audit working papers which may contain confidential and proprietary information. Further, we are not convinced that internal auditors have the capabilities and resources to conduct a comprehensive and cost effective peer review. We have no objection, however, to our independent public accountant reviewing our internal audit function on a periodic basis.

Recommendation 6. Public companies should ensure that their internal audit functions are objective.

106c

Mr. Arnold
June 30, 1987
Page 4

Although we support the concept of an objective internal audit function, we are concerned with the text accompanying the recommendation wherein the Commission encourages an administrative reporting relationship in which the chief internal auditor reports directly to the CEO.

In our view, it is unnecessary that the administrative reporting relationship of the chief internal auditor be restricted to the CEO for the function to be effective and objective. At Kimberly-Clark, our chief internal auditor reports administratively to a Senior Vice President and General Counsel (a direct deputy of our Chief Executive Officer). In addition, our chief internal auditor has direct, private and unencumbered access to both our audit committee and our CEO. We believe this reporting relationship and functioning of the chief internal auditor ensures objectivity. There are, no doubt, other administrative reporting relationships that would likewise ensure objectivity in other organizations.

Accordingly, we believe the Commission should not attempt to prescribe the reporting relationship for the chief internal auditor, but rather require the audit committee review and endorse the reporting relationship.

The text following the recommendation states that, "The chief internal auditor should be an experienced audit professional ..." While this may often be desirable, it should not be an absolute requirement. Depending on the size of the internal audit function and complexity of the entity, prior audit experience may be less essential than other attributes such as leadership skills, significant knowledge of a particular business, broad business and organizational skills, integrity, and the ability to function effectively with other senior executives of the entity. In our view, previous auditing experience is not always essential to the overall effectiveness of the chief internal auditor. We strongly believe that companies must have the latitude to staff such a position based on what they deem to be the appropriate qualifications.

Recommendation 7. Internal auditors should consider the implications of their nonfinancial audit findings for the company's financial statements.

We support the recommendation.

106d

Mr. Arnold
June 30, 1987
Page 5

Recommendation 8. Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.

In our view, the notion of "appropriate involvement by the internal auditors at the corporate level" as suggested in the text may not be workable without duplication of audit effort and an increase in audit costs. Generally accepted auditing standards require the independent auditor to perform many corporate audit functions directly (e.g., test and review the consolidation process or income tax accruals) in order to express an opinion on the financial statements and any overlap by internal audit at the corporate level may, therefore, be duplicative and more costly.

In addition, we believe that the limited exposure by the internal auditing staff to the consolidation process (they would perform only one year-end examination and perhaps three quarterly reviews each year), together with the requisite need to be an expert in the applicable FASB and SEC accounting requirements, would handicap the internal audit staff due to their limited dealings with these matters. Also, we believe that "involvement at the corporate level" may cause the internal audit staff to be uncomfortable in discharging the added responsibility suggested by the Commission.

Recommendation 9. The board of directors of all public companies should be required by SEC rule to establish audit committees comprised solely of independent directors.

We support the recommendation.

Recommendation 10. Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.

We support the recommendation. We realize that the Commission has attempted to qualify the "authority" of the Audit Committee Good Practice Guidelines contained in Appendix K. Nevertheless, we believe that these "guidelines" will become the minimum standards of audit committee performance. Accordingly, we have the following observations on selected duties and responsibilities contained in the Good Practice Guidelines.

106e

Mr. Arnold
June 30, 1987
Page 6

- Guideline
The committee should determine the open years on federal income tax returns and whether there are any significant items that have been or might be disputed by the IRS, and inquire into the status of the related tax reserves.

Observation
We believe the task of "determining whether there are any significant items that have been or might be disputed by the IRS" to be beyond the capabilities of most audit committee members and also would extend the function of the audit committee into those of management. We believe the audit committee's oversight role properly would be fulfilled if the committee would inquire of the independent accountant whether he believes the tax accruals have been reasonably stated by management in view of actual or potential disputed IRS items.

- Guideline
The committee should review with management the MD&A Section of the Annual Report and ask the extent to which the independent public accountant has reviewed the MD&A Section. The committee should inquire of the independent public accountant if the other sections of the annual report to stockholders are consistent with the information reflected in the financial statements.

Observation
We have no objection to the audit committee reviewing with management the MD&A section of the annual report.

However, we are concerned that the inquiry of the public accountant of the extent to which he has reviewed the MD&A section may ultimately lead to increase audit fees and less robust and meaningful MD&A sections in annual reports.

There is currently no requirement that MD&A be audited by the independent public accountant, although the AICPA has a draft Statement on Auditing Standards for examining and reporting on MD&A. We are fearful that audit committees, in a defensive attitude, will begin to insist that the independent accountant examine MD&A if audit committees are "required" by the Good Practice Guidelines to make such inquiry. Some committee

108

Mr. Arnold
June 30, 1987
Page 7

members may feel that a negative response by the independent accountant to the inquiry connotes a "deficient performance." Requiring independent auditor examination of MD&A will, no doubt, lead to increased audit fees and a much narrower focus of MD&A if it is restricted to only that which the auditor is able to test and examine. We feel that the narrower-focused MD&A will, in turn, represent a step backward in shareholder communications.

With respect to the last sentence of the Guideline, existing generally accepted auditing standards require the auditor to make such a "consistency" determination, and, for the Commission to require the audit committee to make inquiry as to the auditor's performance of a generally accepted auditing standard seems redundant.

Recommendation 11. All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it at least annually, and modify it as necessary.

We support the recommendation but believe directors only need to review the audit committee's charter periodically rather than annually.

Recommendation 12. Audit committees should have adequate resources and authority to discharge their responsibilities.

We support the recommendation.

Recommendation 13. The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.

We support the recommendation.

Recommendation 14. The audit committee should approve in advance the types and the extent of management advisory services that management plans to engage the company's independent public accountant to perform.

This particular recommendation has limited applicability to Kimberly-Clark because we usually have any needed management advisory services (MAS) performed by someone other than our independent public accountant. However, for those companies

(b6g)

Mr. Arnold
June 30, 1987
Page 8

that do engage their independent public accountants to perform MAS, we believe audit committee approval either before or after the fact should suffice if the intent of the recommendation is to ascertain whether the MAS engagement somehow compromised the independent accountant's independence. (See the previous recommendation.)

Recommendation 15. All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and chief accounting officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

Since 1980, Kimberly-Clark has been voluntarily including a statement of Management's Responsibility for Financial Statements in its annual report to stockholders and, accordingly, we support the concept of a "management report," although our present "statement" is unsigned.

The text accompanying the recommendation suggests that CEOs should periodically engage independent accountants to examine and opine on the company's system of internal accounting control. Many companies, including Kimberly-Clark, spend considerable sums each year to ensure the maintenance of an effective internal accounting control system which is examined and tested throughout the year by internal auditors. We continue to believe that further examination of internal accounting control by independent auditors cannot be cost justified. We, therefore, recommend that the Commission remove the suggestion that the independent accountant perform a special examination of the internal accounting control system.

The sample management report contained in the Good Practice Guidelines for Management's Report in Appendix L contains the following negative reference which we strongly urge be removed or modified in the final Treadway Report.

- A statement that the financial statements "are not misstated due to material fraud or error."
- A statement that representations made to the CPA by management are "valid and appropriate."

106h

Mr. Arnold
June 30, 1987
Page 9

- A statement that management maintain a system of internal control that provides reasonable assurance as to the "prevention and detection of fraudulent financial reporting."

With respect to the first two references, we believe that each statement would need to be prefaced by "to the best of our knowledge and belief," and to say more would be neither appropriate nor accurate. More importantly, we believe the negative connotation of the above statements in the overall context of the report is unnecessary and diminishes other important matters in the "Responsibility Statement."

Recommendation 16. All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

We believe this recommendation is unnecessary. Most companies, including Kimberly-Clark, have included a paragraph in their Management Report explaining the composition, scope and functioning of their audit committee. We believe the separate letter from the audit committee chairman may represent information overload and may contain information that is redundant of that contained in the Management Report or the Report of the Independent Accountants. We, therefore, suggest that the recommendation be redrafted to permit disclosure of audit committee matters either in Management's Report or a separate letter from the chairman of the audit committee.

Recommendation 17. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.

The accompanying text states that "Management has, and should have, the prerogative to seek second opinions." We agree. As a consequence, we believe the only time when management should be obliged to report second opinions to the audit committee is when the company relied on a second opinion with which the company's independent accountants disagreed. To report all "second opinion" matters to the audit committee could result in information overload and poor use of their time and management resources.

Recommendation 18. When a public company changes independent public accountants, it should be required by SEC rule to disclose publicly the nature of any material accounting or auditing issues discussed with its old and new auditors during the three-year period preceding the change.

106I

Mr. Arnold
June 30, 1987
Page 10

We support the existing SEC requirement which calls for public disclosure of "... any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his report to the subject matter of the disagreement ..."

The expansion suggested by the recommendation to disclose "discussions" on accounting or auditing whether or not there was disagreement seems unnecessary and could be an impediment to a change in auditors that is being considered for reasons unrelated to accounting or auditing matters, such as better service or lower audit fees. In addition, keeping a log of all such discussions and requiring the public to read through routine discussions in order to locate one that involved a disagreement is an unnecessary burden on all involved.

Recommendation 19. Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release.

We strongly disagree with this recommendation. Requiring the audit committee to approve the financial results prior to their release to the public could well result in an unnecessary delay in timely reporting of interim results by management. In our view, the Commission has not demonstrated that lack of audit committee involvement in the quarterly reporting process has resulted in fraudulent financial reporting, especially when one considers the implications of the Commission's recommendation later in the Treadway Report, with which we agree, for "improved quarterly reporting" by requiring a timely review of quarterly results by the independent accountant.

Recommendation 20. The Commission's sponsoring organizations should establish a body to guide public companies on internal controls.

In view of all of the rulemakers (e.g., FASB, SEC, AICPA Accounting Standards Executive Committee, FASB's Emerging Issues Task Force, and AICPA Auditing Standards Board), the establishment of yet another body seems unnecessary. We suggest that internal control guidance, if any is needed, can be handled adequately by an existing or reconstituted rulemaking body.

106)

Mr. Arnold
June 30, 1987
Page 11

Chapter Three - Recommendations for the Independent Public Accountant

In general, the recommendations for the independent public accountant are logical and, except for the following, we support them.

Recommendation: The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.

The Auditing Standards Board of the AICPA has proposed such a revision. However, we believe the revised standard report does not represent any real improvement and is likely to widen rather than narrow the so-called auditor "expectation gap," a gap between investor's expectations from the audit process and what the CPA is actually delivering in his standard report on the financial statements. A copy of our response to the Auditing Standards Board is attached.

Chapter Four - Recommendations for the SEC and Others to Improve The Regulatory and Legal Environment

In general, we support, or have no comments to offer, on these recommendations except for the following.

Recommendation: The SEC should have authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding.

We believe the imposition of money penalties by the SEC might be an effective enforcement remedy if the standard for assessing such fines were made clear to the public at large. In the text accompanying the recommendation, the Commission speaks of "depriving perpetrators ... of ill-gotten gains ... would help maintain public confidence ...". The meaning of "ill-gotten gains" is too vague to act as an effective guide. A clear standard for money penalty should be identified for a specific fact or set of facts. In addition, a determination should be made of what extent a money penalty would serve to either restrict, deter or punish fraudulent financial reporting.

106K

Mr. Arnold
June 30, 1987
Page 12

Recommendation: The SEC should seek explicit statutory authority to bar or suspend corporate officers or directors involved in fraudulent financial reporting from future service in that capacity in a public company.

Although we agree with the intent of the recommendation, we suggest that the phrase "involved in" is too broad and needs to be more specific. Perhaps, the words "involved in" should be changed to "convicted of a felony involving" in order to sharpen the focus of what is actually intended by the recommendation.

Chapter Five - Recommendations for Education

The Commission's recommendations in Chapter Five appear reasonable.

Conclusion

We would be pleased to discuss any of our observations with the Commission or its staff if they so desire.

Sincerely,



David W. Dusendschon

DWD/dc
DWD-101-87



June 30, 1987

Chairman and Commissioners
National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue N.W.
Washington, D.C. 20006

Dear Chairman and Commissioners:

We congratulate the Commission on a job well done, and respectfully submit the attached comments on behalf of the management and the Audit Committee of the Board of Directors of Southern New England Telecommunications Corporation (SNET). Please note that our comments apply only to those recommendations that pertain to audit committees or internal auditing for which we have proposed revisions.

We endorse the report's overall direction and emphasis and, in particular, agree with and strongly support the position of the Commission as stated on page 5 of the Exposure Draft that a "key practice is the board of directors' establishment of an informed, vigilant and effective audit committee to oversee the company's financial reporting process." The Board of SNET took such action some time ago. The Audit Committee is aware of its responsibilities, and endeavors to act in the required manner at all times.

Daniel J. Miglio
Senior Vice President
Finance & Planning

James R. Greenfield
Chairman of the Audit
Committee

Attachment

3124N/p1

107a

**RESPONSE TO THE REPORT OF THE NATIONAL COMMISSION
ON FRAUDULENT FINANCIAL REPORTING EXPOSURE DRAFT**

**SUBMITTED BY THE MANAGEMENT AND
AUDIT COMMITTEE OF THE BOARD OF DIRECTORS OF
SOUTHERN NEW ENGLAND TELECOMMUNICATIONS CORPORATION (SNET)**

NOTE: ALL BOLD TYPE ITEMS ARE QUOTES FROM THE COMMISSION REPORT TEXT

SOURCE: CHAPTER TWO - RECOMMENDATIONS FOR THE PUBLIC COMPANY - Tone at the Top, page 29.

COMMISSION Recommendation: **"For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated."**

SNET Comment: AGREE, WITH PROPOSED REVISIONS TO THE RECOMMENDATION.

The Commission is correct in identifying management's responsibility in the area of risk assessment. However, we disagree with the discussion beneath the recommendation which states that, **"In addition, the audit committee of the board of directors should review annually the company's risk assessment process and management's responses to significant identified risks."** We believe that such reviews are not properly part of the responsibilities of the audit committee, and are an unnecessary burden that would necessarily reduce the time available to the audit committee for oversight of those actually responsible for such reviews, namely, the auditors.

We believe recommendations should be added in subsequent sections to identify the responsibility for review of management's risk assessment program as belonging to the internal and external auditors. It would then become the duty of the audit committee to ensure that the auditors are properly performing their responsibilities. We also believe that these reviews should not be performed annually, but continuously.

SOURCE: CHAPTER TWO - RECOMMENDATIONS FOR THE PUBLIC COMPANY - Two Key Functions: Accounting and Internal Audit, page 33.

COMMISSION Recommendation: "Public companies should ensure that their internal audit functions are objective."

SNET POSITION: AGREE, WITH COMMENTS.

Objectivity is absolutely required of the internal audit function. However, we disagree that objectivity is jeopardized without placement of the function reporting "administratively to a senior officer who is not directly responsible for preparing the company's financial statements."

In our opinion, this is unnecessary as long as the chief internal auditor has "direct and unrestricted access to the audit committee," meets "privately with the committee on a regular basis," is "an experienced audit professional," and "attends all audit committee meetings." In addition, we agree that "the audit committee should review the appointment and the dismissal of the chief internal auditor." These controls should be sufficient to maintain objectivity.

157c

SOURCE: CHAPTER TWO - RECOMMENDATIONS FOR THE PUBLIC COMPANY - Two Additional Recommendations, page 42.

COMMISSION Recommendation: "Audit committees should increase their oversight of the quarterly reporting process. This oversight should include approving financial results prior to public release."

SNET POSITION: DISAGREE.

We do not believe that the audit committee should approve quarterly financial results prior to public release as this is management's responsibility. The chief accounting officer has specific duties related to the quarterly reporting process; since this officer serves at the discretion of the full board, adequate oversight is thus provided. The external auditor also serves at the recommendation of the audit committee, and has responsibility to inform the audit committee of any problems in this area. In our opinion, the review of the annual financial statements that is performed by the audit committee is adequate.



Bankers Trust Company

280 Park Avenue, New York, New York 10015

George J. Vojta
Executive Vice President
Telephone: 212-850-1072

Mailing Address:
P.O. Box 318, Church Street Station
New York, New York 10015

June 26, 1987

National Commission on Fraudulent
Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Re: April 1987 Exposure Draft of the Report of the
National Commission on Fraudulent Financial Reporting

Gentlemen:

In general, Bankers Trust New York Corporation supports the overall objectives of the draft report and we are pleased to note that most of your recommendations have been in place in our company for many years. However, we are concerned about the quasi-management role for audit committees reflected in several of your recommendations which we believe is incompatible with an audit committee oversight function.

We, therefore, urge the Commission to reconsider the recommendations requiring the audit committee to:

- . Approve quarterly financial results prior to public release.
- . Approve in advance management advisory services to be performed by independent public accountants.
- . Be advised of management's research and discussion of alternative approaches ("second opinions") to significant accounting issues not involving a change of auditors.

Requiring the audit committee to perform these management functions would place it in an operating role, thus creating a basic conflict in its role as an independent arm of the board of directors.

109a

National Commission on
Fraudulent Financial
Reporting

- 2 -

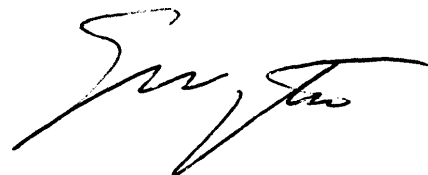
June 26, 1987

We further urge the Commission to reconsider the recommendations for corporate annual reports to include a report that acknowledges management's responsibilities and a letter describing the audit committee's responsibilities and activities. We do not believe that these recommendations will result in improved communication with financial statement users to any meaningful degree.

The Commission is urged to reflect in its final report the enhancement of the role of the audit committee which would be achieved through many of your recommendations. The audit committee role, however, should not be broadened to include responsibilities which are traditionally and properly the role of management. We believe this is unfair to the audit committee, as well as to management.

Thank you for the opportunity to comment on this exposure draft.

Very truly yours,

A handwritten signature in cursive script, appearing to read "E. J. [unclear]".

110



WELLS FARGO BANK

DOYLE L. ARNOLD
Senior Vice President &
General Auditor

525 Market Street
San Francisco, CA 94163

June 29, 1987

National Commission on Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, DC 20006

Dear Members of the Commission:

This letter responds to your request for comments on the Commission's "Exposure Draft" dated April 1987.

Overall, the work of the Commission is to be commended. The Exposure Draft is generally thoughtful, presents many potentially useful recommendations, and particularly merits attention for its focus on the importance of the "tone at the top" as an important factor in deterring fraudulent financial reporting.

However, I believe that two specific recommendations warrant further consideration and modification in the final report. Each is discussed further below. In addition, one significant comment is submitted regarding the overall costs and benefits of the Commission's recommendations.

Section III-B. Internal Audit Function and Chief Internal Auditor--IIA Standards (p. 33)

In its discussion of the recommendation that public companies adopt IIA standards, the Commission specifically "endorses (the) concept of" the IIA Quality Assurance Standard calling for periodic external peer reviews. I believe that this recommendation has merit, but only if it is flexibly and intelligently applied. Banks and bank holding companies undergo frequent examination by federal and/or state regulatory and supervisory authorities. Almost all such examinations include some review of the internal audit function, and at least the National Bank Examiners of the Office of the Comptroller of the Currency periodically single out internal audit for an intensive "target examination."

These regulatory reviews more than adequately comport with the concept of a periodic external peer review of the quality of the internal audit function. To require an additional peer review solely of compliance with IIA standards is not cost justified in such circumstances and should not be required.

Section III-B. Internal Audit Function and Chief Internal Auditor--
Objectivity of the Internal Audit Function

The Exposure Draft recommends that "Public Companies should ensure that their internal audit functions are objective" and should have regular access to the CEO and to the audit committee. I agree.

The discussion of the recommendation, however, also states on page 34 that "(t)he chief internal auditor should be an experienced audit professional, trained either in internal auditing or in public accounting, . . ." On this I strongly disagree with the Exposure Draft. Certainly the chief internal auditor should have adequate knowledge of accounting and of internal control techniques. However, there are many ways to acquire such knowledge other than by being a "professional, trained either in internal auditing or in public accounting." This recommendation is dangerously close to requiring some form of certification, for which no support is given by the Commission.

At Wells Fargo & Company, the CEO selects a member of senior management to serve as chief internal auditor for a period of several years. The individual selected is qualified for the job by virtue of knowledge and experience. Almost by definition, that individual has "the necessary business acumen to work effectively with fellow senior officers" and "occup(ies) a position of high stature within the organization," as recommended by the Commission. However, that individual, by conscious design, is not always an "audit professional." I am aware of several other major corporations that operate strong internal audit functions very successfully under a similar approach.

The discussion of this recommendation should be modified to focus simply on qualifications. It should not be a potentially thinly disguised attempt to require CPA or CIA certification.

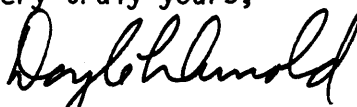
Finally, it should be noted that many of the recommendations contained in the Exposure Draft will result in increased costs for public companies. However, nowhere has the Commission quantified these costs or the benefits expected to flow from implementing its recommendations. The Exposure Draft does note that the Commission concluded (p. 4) that "quantification (of the problem of fraudulent financial reporting) proved to be impossible." However, the Draft does not even demonstrate that whatever problem of fraudulent financial reporting exists has grown worse since the last major change in auditing and reporting standards, nor does it even note any attempt at quantifying the costs of adopting its recommendations.

110b

National Commission on Fraudulent Financial Reporting
Comments on Exposure Draft
June 29, 1987

I would submit that no public policy of this magnitude should be recommended or adopted without some reasoned attempt to weigh its costs and benefits. The most disappointing aspect of the Commission's draft is that such an attempt, if it was made, was not itself described and submitted to public scrutiny and comment.

Very truly yours,



Doyle L. Arnold



June 29, 1987

ROBERT L. CARLETON
VICE PRESIDENT, CONTROLLER

National Commission On
Fraudulent Financial Reporting
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006

Dear Sirs:

PepsiCo, Inc. is pleased to have the opportunity to present its views to the Commission on the Exposure Draft on Fraudulent Financial Reporting. Our comments have not yet been reviewed with our Audit Committee because of the short deadline set by the Commission for responses.

Overall, we agree with the focus, conclusions and recommendations in the report. We commend the Commissioners and the Commission's sponsors for undertaking this important private sector initiative. We are limiting our specific comments to the recommendations for the public company. We have reviewed the recommendations for the other groups and have no major objections to them. Furthermore, we believe any substantive recommendations can more appropriately be made by professionals within these groups.

Our specific comments are:

- o We do not believe a letter in the annual report signed by the Audit Committee Chairman is particularly useful. We disagree with the Commission's conclusion that the present proxy statement disclosures concerning the Audit Committee's responsibilities and roles are inadequate. Furthermore, we don't believe this letter will serve the Commission's stated purpose "to reinforce the Audit Committee members' awareness and acceptance of the importance of their responsibilities." Instead, we believe the letter will become a routine, annual submission that may confuse the reader as to who is primarily responsible for the financial statements.

111a

PEPSICO

-2-

- o We disagree that the Audit Committee should approve, in advance (or at anytime), the release of quarterly financial results to the public. We believe this requirement is too detailed a procedure to require of the Committee. Practically, it would be administratively difficult and delay the reporting of quarterly financial results. It also could increase the risk of information leaks.

We offer these comments in a constructive manner and we are pleased that we are both in agreement and in compliance with so many of the Commission's recommendations.

Sincerely,



R. L. Carleton
Vice President and Controller

cc: D. W. Calloway
R. G. Dettmer
C. C. Garvin