PUBLIC OVERSIGHT BOARD

Annual Report

1994-1995

POB

REMARKS OF AN INDEPENDENCE ADVISORY PANEL MEMBER

Recently Ralph S. Saul, an Advisory Panel member, corporate director, and former Chairman and CEO of CIGNA Corporation, addressed partners of a large accounting firm about auditor independence and the Panel's report. Mr. Saul's remarks about the importance of auditor independence to our financial markets, and his concerns about the future of the profession, provide important insights from the perspective of a business executive and corporate director. We would like to share excerpts from his remarks: We felt it was important to ask basic questions about the issue of independence. I should not have to remind professionals that the stakes in this matter are very high. The investing public relies upon the integrity of financial statements and, despite audit failure, they continue to repose great trust and confidence in the independence and objectivity of the profession. For this reason, anything that threatens to undermine that trust and confidence ...

About the SEC Practice Section and the Public Oversight Board

The SECPS

The SEC Practice Section ("SECPS" or the "Section") was founded in 1977 as part of the Division for CPA Firms of the American Institute of Certified Public Accountants ("AICPA") and is overseen by the Public Oversight Board (the "Board" or the "POB"). The Section imposes membership requirements and administers two fundamental programs to help insure that SEC clients are audited by member accounting firms with adequate quality control systems: (1) peer review, through which Section members have their practices reviewed every three years by other accountants and (2) quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms relating to SEC clients and certain other entities to determine if the firms' quality control systems require redesign or there should be stricter compliance with the firms' quality control policies and procedures and/or the Section's membership requirements.

Currently, the requirements of the SECPS affect more than 105,000 professionals at 1,260 member firms that audit more than 15,800 SEC clients.

The POB

The POB is an autonomous body of five members with a broad spectrum of business, professional, regulatory and legislative experience. The Board's independence is assured by its power to appoint its own members, chairperson and staff, set its own budget, and establish its own operating procedures. It oversees all SECPS activities.

The Board's primary responsibility is to represent the public interest (1) when the Section sets, revises or enforces standards, membership requirements, rules or procedures and (2) when SECPS committees consider the results of individual peer reviews or the possible quality controll implications of litigation alleging audit failure. The Board interprets its responsibilities to also include the monitoring of all matters and developments that may affect public confidence in the integrity of the audit process. In this regard, the 1994 Annual Report of the Securities and Exchange Commission ("SEC") to the U. S. Congress not only comments favorably on the POB's oversight of the profession's quality control efforts, but also observes for the first time that the POB "also engages in other activities directed towards improvements in the financial reporting process."

The Advisory Panel on Auditor Independence

At its September 1994 meeting, the Board received the report of its Advisory Panel on Auditor Independence entitled *Strengthening the Professionalism of the Independent Auditor*, which describes the most critical problems confronting the accounting profession and urges the adoption of a corporate governance approach to improved financial reporting. The Board focused during the last year on encouraging acceptance and implementation of the Panel's recommendations.

In that regard, the Board recognized the need to communicate to corporate directors and senior corporate management the recommendations discussed in the Panel's report for strengthening the relationship between the board of directors and the independent auditor to help directors meet their governance responsibilities and improve the quality of financial reporting. This led the Board to prepare a summary report, *Directors, Management, and Auditors—Allies in Protecting Shareholder Interests*. The Board has distributed the report to the chief executive, and financial officers, and each director of all companies on the New York Stock

Exchange and of other SEC registered companies with revenues of at least $250 million. To date over fifty thousand copies of this report have been distributed. The report includes an action plan for audit committees that is reproduced on the last page of this annual report of the Board.

Internal Auditing Outsourcing

The Board and staff also devoted considerable attention to the independence implications of a CPA firm's performance of internal audit services for audit clients. The staff of the SEC expressed concerns with performance of such services at the AICPA's Annual Conference on Banking in November 1994 and at the AICPA's National Conference on Current SEC Developments in January 1995. Board members and staff met with regulators, the Institute of Internal Auditors and representatives of CPA firms on this independence issue. In addition, the Board met in April 1995 with representatives of the AICPA's Professional Ethics Division Executive Committee, including its chairperson, to discuss the matter. On June 14, 1995, the Board issued two letters to the Professional Ethics Division.

The staff letter concluded, based on a technical analysis of the professional literature, that the conduct of internal audit services for audit clients need not impair auditor's independence if the auditor does not assume management's operational or decision making responsibilities. The chairman's letter suggested, however, that before an ethical ruling or interpretation is developed to clarify the distinction between managerial and non-managerial functions the sponsoring organizations of the COSO Report, *Internal Control—Integrated Framework*, should be consulted to resolve differing views as to whether internal audit monitoring activities performed by the external auditor are part of the internal control structure.

The Professional Ethics Division Executive Committee met with COSO, the SEC, the POB, and other interested observers in developing an interpretation addressing the independence implications of performing internal audit services for audit clients. We believe that interpretation addresses the Board's and its staff's concerns and provides appropriate guidance to CPA firms providing such services.

Board Meetings

The Board and its staff held seven regularly scheduled meetings during the year directed at overseeing the activities and programs of the SECPS. The Board also met with the commissioners and senior staff of the SEC and with representatives of the Committee on Corporate Reporting of the Financial Executives Institute. The focus of these discussions was the Advisory Panel's recommendations to improve corporate governance over financial reporting. In addition, members of the Board, its chairman and/or staff met with the Comptroller General of the U.S., bank regulatory authorities, officials of the SECPS and the AICPA Board. Also, discussions on a variety of issues relating to the SECPS self-regulatory programs and other matters relating to the integrity of the audit process and financial reporting were held with representatives of the Auditing Standards Board, the chairman and members of the Financial Accounting Standards Board ("FASB") and the Financial Accounting Standards Advisory Council. The Board's chair met with representatives of the accounting profession in the UK responsible for self-regulation to discuss their proposal to form an oversight body patterned after the POB.

The Board's staff also participated in the deliberations and drafting of two exposure drafts of Quality Control Standards, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* and *Monitoring a CPA Firm's Accounting and Auditing Practice*, which were prepared by the Joint Task Force on Quality Control Standards of the Auditing Standards Board ("ASB"). These statements would supersede the current standard and interpretations.

Changes in POB Membership

Donald J. Kirk, who chaired the POB's Advisory Panel on Auditor Independence, was elected to the Board to succeed Robert K. Mautz, who retired on March 31, 1995 after serving as a member of the POB for fourteen years. Mr. Kirk was an original member of the Financial Accounting Standards Board; he served that organization for fourteen years, nine of them as chairman. Prior to his service on the FASB, he was a partner in one of the then-Big Eight accounting firms.

Mr. Mautz, who served as vice-chairman, was the senior member of the Board in terms of service and brought a variety of experience to Board deliberations. Although Mr. Mautz served as a partner in the national office of a CPA firm, his career was essentially in academia. He is Professor Emeritus at both the University of Illinois in Urbana-Champaign and the University of Michigan and served as the editor of the *Accounting Review*, president of the American Accounting Association and founding editor of *Accounting Horizons*. Paul W. McCracken was appointed vice-chairman on Mr. Mautz's retirement.

The John J. McCloy Award

The POB awarded the 1995 John J. McCloy Award for Outstanding Contributions to Audit Excellence to Philip L. Defliese for his numerous professional accomplishments as an active leader of the profession. Those accomplishments included chairing the AICPA, the Accounting Principles Board, the Committee on Auditing Procedure and Coopers & Lybrand. He was a co-author of four editions of the monumental text on auditing, *Montgomery's Auditing*, and was a professor at Columbia University. Neither accounting nor auditing in this country would be what they are today without his efforts and wisdom.

...has an impact far beyond the narrow interest of accountants. Corporate America and its financial officers have a stake in the independence of auditors. That independence enhances the reliability of management's financial statements and gives them a credibility which they would not have without certification. If the relationship between management and the auditors works as it should, the board and shareholders have through the independent audit an important check and balance in the reporting process—a check and balance that works to the advantage of all parties.

Firms need to focus on how the audit function can be enhanced and not submerged in large multi-line public accounting/management consulting organizations. As an outside observer, I don't have a solution to this issue. However, it is shortsighted to look upon auditing as a commodity, a low growth, low margin business. Auditing is the bedrock upon which you have built your present very successful businesses in non-audit services. It doesn't make sense to argue, as some have, that there is something wrong ...

Oversight of the SECPS Executive Committee

A Board member and staff attend each meeting of the SECPS Executive Committee and its Planning Committee and participate as appropriate. The Executive Committee is the SECPS's governing body. It establishes the Section's membership requirements and supervises the activities of the Peer Review Committee ("PRC"), Quality Control Inquiry Committee ("QCIC"), SEC Regulations Committee and the Professional Issues Task Force ("PITF").

The PITF was established as a result of a recommendation in the POB's Special Report, *In the Public Interest*, issued in March 1993, to accumulate and consider practice issues that appear to present high audit risk and to disseminate relevant guidance. The PITF also refers matters that may require a reconsideration or interpretation of existing standards to appropriate standard-setting bodies. During the year, this body issued three *Practice Alerts* entitled "*Auditing Inventories—Physical Observations*," "*Acceptance and Continuance of Audit Clients*" and "*Revenue Recognition Issues.*"

The Board's staff worked closely with a task force formed by the Executive Committee to reevaluate the requirement that member firms conduct a concurring partner review of the financial statements and the firm's report thereon. At its September 1995 meeting, the Committee approved the task force recommendation to revise the Section's concurring partner review requirement so that it now specifies that the concurring partner's review should be sufficient to provide the member firm with additional assurance that audit risk has been restricted to a level acceptable to the firm. The revised requirement suggests the extent of inquiry that should be made of the engagement partner and documentation that should be reviewed by the concurring partner.

Oversight of the Peer Review Process

A primary responsibility of the Board is to oversee, monitor and evaluate the effectiveness of the Section's peer review process, including the activities of its Peer Review Committee. The peer review program is the foundation of the CPA profession's self-regulatory efforts and its principal method of assuring the public that member firms are performing at a level that meets or exceeds professional standards. Because of its importance and scope, the Board and its staff invest substantial resources in assuring that the peer review process is vigorous and effective.

One or more Board members and staff members regularly attend meetings of the PRC, and the Board's staff reports to the entire Board at each of its meetings on the performance of the Committee in setting standards, processing reports and the follow-up of mandated corrective actions, and the performance of individual peer review teams as they discharge their responsibility to perform rigorous peer reviews.

The Board's staff performs monitoring procedures on each peer review administered by the committee. These procedures vary in intensity depending on characteristics of the reviewed firm and reviewer. For example, the staff participates in the field in the reviews of all firms with thirty or more SEC clients and approximately 20% of the reviews of other firms with SEC clients. For all other firms with SEC clients the staff reviews working papers, letters of comments and reports, and makes recommendations to the PRC regarding its evaluation of the peer review.

The Board believes that the peer review process has operated with integrity and vigor during the year and continues to enhance the consistency and quality of auditing by SECPS member firms.

The SEC also oversees the peer review process. Through the office of the SEC's Chief Accountant, its staff randomly inspects peer review working papers and POB oversight files during the course of the peer review year.

During the year, the PRC continued its broad-based "visioning" project which is a "zero-based" re-evaluation of the peer review process. The principal objective of the project is to assure that the peer review process results in continuous improvement in the quality of member firms' audit practices.

Oversight of the Quality Control Inquiry Committee

The quality control inquiry process, administered by the Quality Control Inquiry Committee, supplements the peer review process. The QCIC determines whether allegations of audit failure against SECPS member firms involving SEC registrants indicate a need for those firms to take corrective actions to strengthen their quality control systems or to address personnel deficiencies. In addition, consideration of such allegations may also raise questions that lead to reconsideration or interpretation of professional standards or suggest audit practice issues where practical guidance would benefit practitioners. The QCIC refers such matters to the PITF.

The QCIC also has the authority to inquire into litigation involving non-public entities where there is significant public interest and also into complaints filed against auditors by federal and state regulators alleging audit failure in the conduct of an audit of a financial institution.

Section member firms are required to report and provide to the QCIC copies of complaints within 30 days of being served. This requirement includes all litigation involving the firm or its personnel, or any publicly announced investigation by a regulatory agency, that alleges deficiencies in the conduct of an audit of an SEC registrant and certain other entities. The QCIC reviews the complaints, financial statements and regulatory filings, trustee reports, SEC enforcement releases and other publicly available documents. If the case is not deemed frivolous, the QCIC meets with representatives of the accused firm. The QCIC also may review audit documentation and firm guidance material for the purpose of determining whether the allegations against the firm indicate a need for the firm to strengthen quality controls or issue additional internal guidance. The QCIC occasionally becomes aware of behavior by individual CPAs that warrants investigation. The QCIC refers such matters to the AICPA Professional Ethics Division.

The Board and its staff actively oversee all QCIC activities. All committee and task force meetings are attended by the Board and/or its staff and the Board has unrestricted access to all committee deliberations and files. During the 1994-95 year, the Board's staff participated in all 32 QCIC task force meetings when QCIC members and AICPA staff discussed the allegations contained in specific cases with representatives of the firms reporting the litigation. The Board's staff prepares comprehensive reports on individual cases for the Board's information and responds to Board inquiries about the process. The Board and its staff are also actively involved in the identification and communication of areas where professional standards should be augmented. The Board believes that the QCIC process effectively complements the peer review process and that appropriate consideration was given to the 45 cases closed during the year.

The SEC staff reviews the QCIC process and the attendant POB activities. The SEC staff visits the POB's offices several times a year to review the QCIC

Major Corrective Measures Imposed by the Peer Review Committee to Ensure that Quality Control Deficiencies are Corrected

	Number of Times	
Action	**During 1994**	**Since Inception**
Accelerated peer review	3	51
Employment of an outside consultant acceptable to the Peer Review Committee to perform preissuance reviews of financial statements or other specified procedures	7	66
Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions	13	187
Review of the planning for and results of the firm's internal inspection program	37	279
Review of changes made to the firm's quality control document or other manuals and checklists	0	42
Continuing Professional Education in specified areas	5	*39

** Since July 1, 1988, as data for prior years is no longer available.*

...with the growth of non-audit services within public accounting firms. The growth of these other services stemmed naturally from what auditors do and from the firms' accumulated knowledge about their clients. What is different now is that these businesses have become the "tail wagging the dog" and created organizational and management problems within the firms which gave them birth. How this issue will be dealt with over the coming years will have a lot to do with the future of the profession.

Only one word of advice and that is the task of strengthening the independent audit lies in large part with the profession. It must have a vision of excellence for the independent auditor. Clients, regulators and the investing public cannot build that vision if the profession feels that its self interest lies in pursuing another course. Such a course would be dangerous and would certainly lead to a far different profession, one that over the long run would command the respect of neither clients nor the investing public.

prepared final memoranda and the POB files on each case and discusses the cases with the POB and QCIC staffs.

During the past year, the QCIC implemented several Board suggestions to improve the effectiveness and the timeliness of the process. Cases are assigned to QCIC task forces shortly after complaints are received, instead of waiting for the full committee to discuss the case and decide on a course of action. Also, documentation of the rationale and conclusions reached by QCIC task forces is now being prepared in advance of the full committee meeting at which time the case is considered for closure. This allows the Committee to better focus on and challenge the propriety and rationale for closing a case prior to taking a formal vote.

The Independence Advisory Panel Report

As reported earlier, the Board appointed an Advisory Panel on Auditor Independence because of issues raised in a January 1994 speech by the Chief Accountant of the SEC. In September 1994 the Advisory Panel issued its report, *Strengthening the Professionalism of the Independent Auditor*. The Panel's recommendations are aimed at improving auditor independence and the relevance and reliability of audited financial statements.

In our 1994 Annual Report, the Board committed to urging those to whom the Panel's recommendations were directed to take action to implement them. In carrying out this commitment, over the past year the Board engaged in numerous meetings and discussions with leaders of the profession, individual accounting firms, standard setters, regulators and private sector organizations. We are encouraged by the broad-based interest in, and support for, implementation of the Panel's suggestions.

In particular, we are pleased to report that the SECPS Executive Committee

Results of QCIC Activity

	11/1/79 through 6/30/94	7/1/94 through 6/30/95	Totals
Actions Related to Firms			
Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected	60	2	62
A firm took appropriate corrective measures that were responsive to the implications of the specific case	89	8	97
Actions Related to Standards			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	40	5	45
The Professional Issues Task Force was asked to consider the issuance of a practice alert	6	1	7
Actions Related to Individuals			
The case was referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals	25	3	28
	220	19	239

(**Note:** *Frequently more than one action is taken by the QCIC or by the firm.*)

appointed a task force to study and respond on behalf of its membership to the recommendations by the Advisory Panel. That task force met with members and representatives of the Advisory Panel and the Board on numerous occasions to ensure there was a complete and thorough understanding of the Panel's recommendations and why they were made. The SECPS's response to the Advisory Panel's report is supportive and includes the following conclusion:

> The SECPS commends the Advisory Panel for its thought provoking analysis of auditor independence and corporate governance. The Advisory Panel's observations and suggestions present all participants in the system of corporate governance—management, audit committees, boards of directors, independent auditors and regulatory agencies—with a challenge and opportunity to elevate the quality of financial reporting. In order to optimize the opportunity, each of these groups should give appropriate consideration to the challenge the Advisory Panel presents to it and promptly act thereon. The SECPS will work with the Public Oversight Board in developing an appropriate plan of action for the accounting profession in this important endeavor. Recognizing that progress requires action by all participants in the corporate governance process, the SECPS will also help other groups address the Panel's recommendations directed to them.

The Board's recently published booklet, *Directors, Management, and Auditors—Allies in Protecting Shareholder Interests*, was to assist SECPS member firms, corporate financial management and audit committees in implementing a principal Panel suggestion—that corporate boards and audit committees should expect to receive, and the independent auditor should deliver, forthright, candid oral reports in a timely manner on the ***quality***—not just acceptability—of a company's financial reporting. That quality assessment should be based on judgments about the appropriateness, aggressiveness or conservatism of selected or contemplated accounting principles and estimates, and the clarity of disclosures.

The Board and Panel members will continue to seek opportunities to assist in implementation of the Panel's suggestions. We believe that the Panel's conclusions are sound and can help prevent further erosion of confidence in the accounting profession and in the integrity of the financial information on which our economic system depends.

Audit Independence

During the past year the Board has observed the continuation and acceleration of a trend it first commented upon in its 1988-89 Annual Report:

> Public accounting firms are undergoing organizational metamorphoses and becoming involved in an ever-expanding scope of services for present and prospective clients. These services provide obvious profit opportunities for individual firms. While profits ensure the ability of a firm to provide quality audit services and enhance its ability to attract top quality people to the firm, the profit motive cannot be permitted to endanger the "professionalism" of firms.
>
> The maintenance of the traditional concepts of professionalism, which embody integrity, objectivity, and competence, is essential. The profession at large and individual firms must be constantly mindful of the social importance of auditing and not judge professional success solely in economic terms.

Among the ever-expanding services now provided by accounting firms directly, or through affiliates, are extended audit services (outsourced internal auditing), business risk assessments, traditional investment banking services, expatriate payroll services and human resources outsourcing. Such new service lines often have different characteristics from the traditional management consulting services provided by accounting firms.

The Board reported elsewhere in this Annual Report that our analysis of extended audit services led us to conclude that if properly and carefully structured, such services need not impair audit independence. Nonetheless, as accounting firms seek new opportunities to expand non-audit services, we believe many of these new lines of business present new challenges to traditional independence concepts. The Board urges the profession to step back and evaluate the totality of the impact of the kinds of services discussed above, including the ways in which they are promoted and provided, on the public's perception of objectivity and independence. The profession's Code of Professional Conduct states that "For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact ***and appearance.*** In providing all other services, a member should maintain objectivity and avoid conflicts of interest." The Code also requires an assessment as to whether an activity is consistent with the firm's professional role. For example, is the activity a reasonable extension or variation of existing services?

All of this suggests that it is timely and appropriate for the profession to consider whether the Code of Professional Conduct provides an adequate framework and guidance for addressing in a timely manner the implications of new service lines, and organizational structures to provide them, on the traditional concepts of independence.

Copies of the reports *Strengthening the Professionalism of the Independent Auditor* and *Directors, Management, and Auditors—Allies in Protecting Shareholder Interests*, or additional copies of this report, can be obtained by contacting the Public Oversight Board's offices.

POB

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From the POB 1995 Report

DIRECTORS, MANAGEMENT, AND AUDITORS—ALLIES IN PROTECTING SHAREHOLDER INTERESTS

What the Audit Committee Should Do

The POB **urges that audit committees take action** to ensure that their charter or terms of reference include or provide for the following:

- An instruction to the independent auditor that the **board of directors**, as the shareholders' representative, **is the auditor's client.**
- An expectation that financial management and the independent auditor perform a **timely analysis** of significant financial reporting issues and practices.
- An expectation that financial management and the independent auditor discuss with the audit committee their **qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices** used or proposed to be adopted by the company and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates.
- An opportunity for the full board of directors to meet with the independent auditor annually to help provide a basis for the board to recommend to shareholders the appointment of the auditor or ratification of the board's selection of the auditor.

The audit committee discussion with the independent auditor about the appropriateness of accounting principles and financial disclosure practices should generally include the following:

- the auditor's independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the company;
- the auditor's views about whether management's choices of accounting principles are conservative, moderate, or extreme from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices;
- the auditor's reasoning in determining the appropriateness of changes in accounting principles and disclosure practices;
- the auditor's reasoning in determining the appropriateness of the accounting principles and disclosure practices adopted by management for new transactions or events;
- the auditor's reasoning in accepting or questioning significant estimates made by management;
- the auditor's views about how the company's choices of accounting principles and disclosure practices may affect shareholders and public views and attitudes about the company.